STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
AIL SYSTEMS, INC.	:	DETERMINATION DTA NO. 819303
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Period Ended September 30, 1997.	:	

Petitioner, AIL Systems, Inc., 455 Commack Road, Deer Park, New York 11729, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the period ended September 30, 1997.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on October 1, 2003 at 10:30 A.M., with all briefs to be submitted by April 2, 2004, which date began the six-month period for the issuance of this determination. Petitioner appeared by Morrison & Foerster LLP (Paul H. Frankel, Esq., Hollis L. Hyans, Esq., and Irwin M. Slomka, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Kathleen D. O'Connell, Esq., of counsel).

ISSUES

I. Whether petitioner is required to recapture an investment tax credit following an election pursuant to Internal Revenue Code § 338(h)(10) which deems the purchase of its stock as a sale of assets.

II. Whether reasonable cause exists for the abatement of penalty imposed for the substantial understatement of tax.

FINDINGS OF FACT

The parties executed a Stipulation of Facts in connection with this proceeding. These stipulated facts are included in the Findings of Fact herein.

1. Petitioner, AIL Systems, Inc., is a Delaware corporation engaged in the business of designing, developing and manufacturing high technology electronics in New York.

2. For all relevant periods, petitioner conducted business in New York State and filed tax returns under Tax Law Article 9-A.

3. Between 1991 and September 30, 1997, petitioner placed in service in New York State property that at the time it was placed in service qualified for the New York investment tax credit ("ITC") ("qualifying property").

4. The qualifying property consisted of computer equipment, machinery and equipment and building improvements.

5. For the tax years 1991 through the short period ending September 30, 1997, petitioner claimed the ITC on its Article 9-A tax returns with respect to the qualifying property.

6. Until September 30, 1997, petitioner was a 95.276% owned subsidiary of AIL Systems Holding Company ("Seller"), which was a wholly-owned subsidiary of Eaton Corporation. AIL Systems, Inc. Employee Stock Plan owned the remaining 4.724% of petitioner.

7. On September 30, 1997, Seller exchanged all of its shares of stock in petitioner in exchange for stock in AIL Technologies, Inc. ("Technologies") and a note from Technologies. The stock exchange gave Seller a 72.07% interest in Technologies. AIL Systems, Inc. Employee Stock Plan (old plan) also exchanged its shares of AIL Systems, Inc. for shares of Technologies. At that point, Technologies owned 100% of the stock in petitioner.

8. Immediately thereafter, Seller sold 82% of its stock in Technologies. Immediately after the closing on that sale, Technologies' stock was owned by the following shareholders: AIL Systems, Inc. Employee Stock Plan (27.93%); Management Buyout Group (10.70%); and, AIL Technologies Employee Stock Plan (new plan) (48.37%). Seller retained a 13% interest in Technologies.

9. For Federal income tax purposes, Seller and Technologies jointly made an election under Internal Revenue Code ("IRC") § 338(h)(10).

10. Pursuant to IRC § 338(a), the September 30, 1997 stock sale was treated by petitioner as a "deemed sale" of petitioner's assets for Federal income tax purposes, such that the transferee of those assets acquired a new basis in those assets.

11. Petitioner continued in business with the same assets in place and under the same Federal employer identification number after the September 30, 1997 stock sale. After the September 30, 1997 stock sale, petitioner ceased being part of Eaton's Federal consolidated tax return ("Old Group") and thereafter filed as part of a Federal consolidated tax return that did not include Eaton or any of Eaton's affiliates ("New Group").

12. Petitioner filed its own Article 9-A return for the short period from January 1, 1997 through September 30, 1997, the date of the stock sale ("1997 short tax year").

13. Petitioner also filed an Article 9-A return for the period October 1, 1997 through December 31, 1997 as part of an Article 9-A combined return for AIL Technologies, Inc. & Subsidiaries that did not include Eaton.

14. The New Group's Article 9-A combined return claimed ITC on the same assets that were included in the deemed sale, at the new basis.

15. Following an audit of petitioner's Article 9-A return for the 1997 short tax year, the Division of Taxation mailed to petitioner a notice of deficiency, dated October 21, 2002, asserting additional liability for New York State corporation franchise tax under Article 9-A of the Tax Law in the amount of $1,543,943.00, and for the Metropolitan Commuter Transportation District surcharge in the amount of $262,470.00, for the 1997 tax year.

16. The Division of Taxation also imposed penalties against petitioner for the substantial understatement of tax.

17. The Division took the position that petitioner disposed of its qualifying property by reason of the IRC § 338(h)(10) election and was required to recapture the previously claimed ITC in the principal amount of $1,802,230.00,[1] resulting in the tax deficiency asserted in the notice.

18. The Division is seeking the recapture of ITC on petitioner's investment of $36,044,600.00 in qualifying property.

19. There is no dispute as to the mathematical computation of the corporation franchise tax assessed by the Division in the notice of deficiency.

SUMMARY OF PETITIONER'S POSITION

20. Dr. Brian J. Cody appeared at the hearing and testified on petitioner's behalf. Dr. Cody is currently employed by InteCap, Inc., an economic consulting and valuation firm based in Chicago, Illinois. He is the managing director and heads the firm's national transfer pricing practice. Dr. Cody received a Ph.D. in economics from the University of North Carolina, and was an instructor in Finance/International Finance at The Wharton School, University of

[1]The difference between this amount and the total amount asserted in the notice of deficiency appears to be an adjustment of petitioner's business allocation percentage based upon an audit determination of an increase in the receipts factor. This adjustment is not at issue in this notice.

Pennsylvania. Dr. Cody was also employed by the Federal Reserve Bank in Philadelphia as a senior economist in the research department, Coopers & Lybrand, LLP as the manager of their economic analysis and inter-company pricing group and Arthur Andersen, LLP, as a partner in charge of their economic analysis inter-company pricing practice. Dr. Cody has also authored numerous publications involving his economic research dealing with the valuation of various transactions and contracts from an economic perspective. At the hearing, Dr. Cody was qualified as an expert in the field of economics.

Dr. Cody's testimony and written report addressed whether the substance of the 1997 stock sale satisfied the economic criteria for the recapture of ITC. From an economic perspective, he characterized the granting of ITC as a long-term economic contract between the State of New York and the taxpayer, wherein the State agrees to forego short-term tax revenue by allowing the ITC and the taxpayer agrees to continually use the qualifying assets in New York throughout their useful life. From an economic perspective, Dr. Cody testified that the transfer of "property rights" is the best indicator of whether there had been a true "disposition" of assets. Dr. Cody noted that no aspect of the 1997 stock sale, including the tax and accounting treatment, affected petitioner's property rights in the qualifying property. He concluded that because the 1997 stock sale had no impact on petitioner's property rights in those qualifying assets, it did not cause a "disposition" of petitioner's assets so as to satisfy the economic criteria for the recapture of ITC.

In conclusion, Dr. Cody testified that petitioner would be unduly restricted with respect to the property if it were treated as having been sold and then purchased by petitioner. This is because, according to Dr. Cody, beginning October 1, 1997, a new seven-year useful life begins with respect to the property, and petitioner must retain the property for that seven-year useful life

or else risk incurring additional recapture. According to Dr. Cody, the Division's policy of treating the stock sale as an asset sale causes the useful life of the property to be stretched out over a longer period of time, possibly as long as 14 years. This results in a diminution of the ITC benefit since it forces petitioner to hold onto the assets longer than the initial seven-year useful life, with the increased possibility of recapture, an obvious detriment to petitioner.

21. Professor Richard D. Pomp appeared at the hearing and testified on behalf of petitioner. Professor Pomp is a professor at the University of Connecticut Law School, New York University Law School and Columbia University Law School. He has testified on behalf of state governments and consulted with the United States Treasury, the Department of Justice, the Internal Revenue Service, the Multistate Tax Commission and numerous state and local governments. Professor Pomp has previously been qualified as an expert witness on at least eight occasions before the Division of Tax Appeals. At the hearing, Professor Pomp was qualified as an expert in the field of state tax policy.

Professor Pomp's testimony and written report stated that the purpose of the ITC program was to make New York State a more attractive location for manufacturers to build or improve their facilities and therefore, the New York State economy. He approached his assignment as trying to place the transaction at issue somewhere on a continuum between two polar points; at one end of the continuum is a stock sale, which does not require recapture, while at the other end is an asset sale, which does require recapture.

According to Professor Pomp, because the ITC is meant as an incentive for taxpayers to invest in New York property, there should be compelling reasons before undercutting the incentive through recapture. In the opinion of Professor Pomp, a Federal Internal Revenue Code § 338(h)(10) election is not a compelling reason, for state tax policy purposes, to undercut the

ITC incentive. Professor Pomp noted that petitioner did exactly what the ITC program invited it to do, invest millions of dollars in qualifying property that it placed in service in New York State, thereby boosting the New York economy and creating jobs for New York residents. He observed that petitioner never disposed of this property, and noted that nothing changed with respect to petitioner's operation of the qualifying property after the 1997 stock sale. In Professor Pomp's opinion, a policy that treats a Federal tax fiction as triggering ITC recapture without the taxpayer having actually disposed of the underlying property undercuts the policy goal behind the ITC to encourage taxpayers to invest in New York property.

CONCLUSIONS OF LAW

A. During the years in issue, Tax Law former § 210(12)(b) allowed for an investment tax credit against the tax imposed by Article 9-A of the Tax Law with respect to certain qualifying property. To qualify, the property had to: (1) be tangible personal property or other tangible property; (2) be depreciable pursuant to Internal Revenue Code ("IRC") § 167; (3) have a useful life of four years or more; (4) have been acquired by purchase as defined in IRC § 179(d); (5) be located in New York State; and (6) be principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floristry, viticulture or commercial fishing (Tax Law former § 210[12][b]). Furthermore, with respect to property disposed of prior to the end of the year in which the ITC is to be taken, Tax Law former § 210(12)(g) provides for the recapture of the credit, which is to be computed based on the ratio which the months of qualified use bear to the months of useful life.

B. Until September 30, 1997, petitioner was a 95.276% owned subsidiary of AIL Systems Holding Company, which, in turn, was a wholly-owned subsidiary of Eaton

Corporation. These corporations were included in the Federal consolidated return filed by Eaton Corporation. On September 30, 1997, AIL Systems Holding Company exchanged all of its stock in petitioner for stock in, and a note from, AIL Technologies, Inc. Immediately thereafter, AIL Systems Holding Company sold 82% of its stock in AIL Technologies, Inc. to a management buyout corporation.

For Federal income tax purposes, AIL Systems Holding Company and AIL Technologies, Inc. jointly made an election under Internal Revenue Code § 338(h)(10). Pursuant to this election, the sale of stock in petitioner was treated as a deemed sale of assets by petitioner, which is then assumed to have distributed the proceeds of that deemed sale as if it were liquidated into its parent, AIL Systems Holding Company. The result of this election was that for Federal purposes the gain on the sale of the stock in petitioner is disregarded in the consolidated Federal return filed by Eaton Corporation and its subsidiaries. Instead, the gain on the deemed sale of the assets was included in the consolidated return and the deemed liquidation of petitioner was viewed as a nontaxable event. In addition, petitioner was deemed to have acquired the assets by purchase, with a stepped up basis. After the deemed sale took place, petitioner claimed the ITC on the property transferred using the stepped-up basis to compute the credit.

C. Tax Law former § 210(12)(g) provides for the recapture of ITC when the qualified property is "disposed of or ceases to be qualifying property." The determination in this matter centers around the question of whether petitioner's election under IRC § 338(h)(10) constitutes the disposition of the qualifying property, thereby triggering the recapture provisions of Tax Law former § 210(12)(g). The term "disposition" is not defined in the Tax Law, but the corporation franchise tax regulations do enumerate specific transactions which are to be considered

dispositions of property. Pursuant to 20 NYCRR 5-2.8(c), a disposition of qualified property includes:

> (1) a sale of the property;
> (2) a liquidation other than as part of a statutory merger or consolidation;
> (3) a legal dissolution of the taxpayer;
> (4) a trade-in of the property;
> (5) a gift of the property;
> (6) transfer upon foreclosure of a security interest in the property;
> (7) retirement of the property before expiration of its useful life;
> (8) condemnation of the property;
> (9) loss of the property due to fire, theft, storm or other casualty; and
> (10) transfer of the property to a corporation not taxable under Article 9-A.

Section 5-2.8(e) specifically enumerates certain transactions which do not constitute dispositions which would require recapture of the ITC. The list includes transactions under IRC § 381(a) (complete liquidation of a subsidiary under IRC § 332); IRC § 368(a)(1)(C) (acquisitions of property from one corporation by another); IRC § 368(a)(1)(D) (transfer of assets); IRC § 368(a)(1)(F) (transactions involving the mere change in identity, form or place of organization); IRC § 368(a)(1)(G) (bankruptcy reorganizations); and reorganizations under IRC §§ 361 and 368(a)(1)(A) (statutory merger or consolidation).

An election under IRC § 338(h)(10) does not appear in these sections defining transactions which do or do not constitute dispositions of real property for purposes of ITC recapture.

D. According to the report submitted by Professor Pomp:

> [t]he New York ITC is an incentive meant to stimulate the purchase of certain types of assets. The goal is achieved by permitting a taxpayer to reduce its tax liability by a percentage of what it spends on the assets. A taxpayer placing qualifying property in service claims the full amount of the credit regardless of how long the property is intended to be used. However, if an asset ceases to be used by the taxpayer, then the amount of the "unearned" part of the credit must be recaptured.

Chapter 1072 of the Laws of 1969 amended Tax Law § 210, at once expanding Article 9-A jurisdictional nexus and replacing "double depreciation with a new tax incentive" in the form of the ITC (Letter of Commr. of Tax & Finance, Bill Jacket, L 1969, ch 1072). The expansion of Article 9-A jurisdiction with the ITC provided "the unique opportunity to make a change in the Tax Law that will both improve our tax climate and provide a net increase in revenues" (Memo of Dept. of Commerce, ***id***). The ITC was intended to encourage expansion of manufacturing within the State, "greatly improving New York's competitive posture and economic climate" (Letter of Commr., ***id***). The 1969 legislation replaced double depreciation provisions with the ITC, because "it is simpler, it is directly related to investment in productive capacity located in New York State, and the benefits are more quickly available" (***id***).

E. New York's ITC was modeled after the Federal investment tax credit enacted in 1962. The legislative history of the Federal ITC, like the New York State ITC, illustrates that the Federal credit was intended to provide growth in the economy by stimulating capital formation, and to improve the United States competitive position abroad by encouraging the modernization and expanded use of capital equipment (S Rep No. 1881, 87th Cong, 2d Sess 153 (1962), 1962-3 CB 707; PL 87-834). The Federal investment tax credit included a recapture provision similar to the one provided in Tax Law former § 210(12)(g).

Where New York and the Federal government have substantially similar tax provisions, it has long been the policy of the courts, whenever reasonable and practicable, to adopt the Federal construction (***see, Matter of Marx v. Bragalini*** , 6 NY2d 322, 189 NYS2d 846, 854). For example, the principle of Federal conformity was applied by the Court of Appeals in ***In re Weiden 's Estate*** (263 NY 107 [estate tax]), ***Matter of Hunt v. State Tax Commn.*** (65 NY2d 13, 489 NYS2d 451 [personal income tax]) and the Appellate Division in ***Matter of Dreyfus***

Special Income Fund v. New York State Tax Commn. (126 AD2d 368, 514 NYS2d 130 ***affd*** 72 NY2d 874 532 NY2d 356 [corporation franchise tax]) and ***Matter of Behm*** (19 AD2d 234, 241 NYS2d 264 ***affd*** 14 NY2d 826; 251 NYS2d 425 [estate tax]). When the principle of Federal conformity is applicable, it is the practice of the courts to utilize Federal regulations as an aid in ascertaining the meaning of the pertinent statutes (***see, e.g., Matter of Dreyfus Special Income Fund v. New York State Tax Commn.***, ***supra***).

F. Prior to the adoption of the 1954 Internal Revenue Code, when a shareholder had acquired the stock of a corporation with the purpose of obtaining the acquired corporation's assets, the acquiring corporation recognized no gain or loss on the liquidation of the acquired corporation (***Matter of Kimbell-Diamond Milling v. Commissioner***, 186 F2d 718). Pursuant to the court's ruling, if one corporation acquired the stock of another corporation as part of a plan to acquire its assets, the transaction would be treated as an acquisition of the acquired corporation's assets, not as a stock acquisition. This came to be known as the "asset-acquisition" doctrine. Upon liquidation of the acquired corporation, the shareholder recognized no gain or loss, and the shareholder's basis in the distributed property equaled the purchase price paid for the stock. The court reasoned that where a taxpayer who is interested primarily in a corporation's assets first purchases the stock and then liquidates the corporation, the separate steps taken to accomplish the desired objective will be treated as a single transaction. So even though the objective was accomplished in the form of a stock purchase, the substance of the transaction was considered to be a purchase of property (***Commissioner v. Ashland Oil & Refining Co.***, 99 F2d 588; ***Orr Mills v. Commr.***, 30 TC 150). In 1954, the ***Kimbell-Diamond*** rule was codified at IRC § 334(b)(2), which treated a purchase and liquidation of a subsidiary as an asset purchase.

G. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") repealed IRC § 334(b)(2) and replaced it with section 338. Under IRC § 338, a corporation that makes a "qualified stock purchase" of the stock of another corporation may elect to treat the transaction as if the target corporation sold all of its assets, at the close of the acquisition date, to a new corporation in a taxable transaction. If the election is made, the target corporation recognizes gain or loss equal to the difference between the deemed sales price (generally, the price paid for the stock) and the target corporation's basis in its assets. Any gain recognized by the target corporation on the deemed sale is in addition to any gain recognized by the selling shareholders with respect to their stock.

Section 338(h)(10) retains the ***Kimbell-Diamond*** doctrine as codified in the repealed section 334(b)(2) to the extent that it provides for a narrow exception to the imposition of tax on both the corporation and the shareholders as a result of corporation income. If stock of a corporation which was a member of a consolidated group is acquired in a qualified stock purchase, the buyer and the selling group may jointly elect, under IRC § 338(h)(10), to treat the target corporation ("old target") as having sold its assets to a new corporation ("new target") in a taxable transaction, while still a member of the selling group. If this election is made, the old target recognizes gain or loss on the sale and takes its assets with a cost basis, but the selling shareholders recognize no gain or loss. This differs from the approach of both prior section 334(b)(2) or section 338 in that the seller, not the purchaser, bears the burden of the tax on the target corporation's asset level gain as a result of treating a stock purchase as an asset purchase. The election must be made jointly by both the purchaser and the seller, as it is the seller who is responsible to pay any tax resulting from the transaction. It is noted that while a regular section 338 election involves a tax on asset gain of the target corporation and a tax on the parent

corporation's gain with respect to the sale of the subsidiary stock, a section 338(h)(10) election eliminates the second level of corporate tax (***see***, Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.42[6][a][7th ed]).

Under the ***Kimbell-Diamond*** and section 334(b)(2) doctrines, "[w]hen the assets were treated as purchased by the acquiring corporation, recapture income was taxed to the liquidating corporation, the investment tax credit recapture provisions were applicable, and tax attributes, including carryovers, of the liquidating corporation were terminated" (General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, HR 4961, 97th Cong., PL97-248). In addition,

> under the elective treatment provided by the bill, any recapture income of the target corporation attributable to the deemed sale of its assets is not to be included in any consolidated return of the acquiring corporation. The target corporation will not become a member of the acquiring corporation's affiliated group until the day following the date of acquisition. Recapture items of the target corporation will normally be associated with the final return of the target corporation (as the selling corporation) ending on the date of acquisition (Conference Report No. 97-760 2d Session, 1982-2 CB 600).

Furthermore, Congress "anticipated that recapture tax liability of the target corporation attributable to the deemed sale of its assets is an item which may result in an adjustment under the regulations (Committee Report on PL97-248). Based on the above, it is clear that Congress intended to retain the ***Kimbell-Diamond*** rationale that the substance of the transaction is an asset sale and to require recapture treatment for such deemed sales.

H. Section 338(h)(10) is a voluntary election which allows taxpayers such as petitioner the opportunity to avoid being taxed at both the corporate and shareholder level. The original basis of the exception was the court's recognition in ***Kimbell-Diamond*** that where a taxpayer primarily interested in acquiring a corporation's assets initially purchases the corporation's stock and then liquidates the corporation in order to acquire the assets, the substance of the transaction

is a purchase of property. Section 338(h)(10) eliminates the need for an actual liquidation. The taxpayers elect to have the stock sale which is in substance an asset acquisition taxed as an asset sale, and avoids tax on the actual stock sale. However, as the stock sale is in essence an asset acquisition, it is proper to consider the election a disposition of the real property and to require the recapture of the ITC previously claimed.

I. In 1986, the Division issued a Technical Services Bureau Memorandum (TSB-M-86[3]C) entitled "New York State Treatment of a 338 Election" which advised taxpayers that elections under section 338 would be considered dispositions of real property for the purpose of ITC recapture. The TSB-M stated that it was the intention of the Division to maintain "New York State's basic adherence to the Federal treatment as outlined in their regulations." The memorandum further states that, for questions relating to "certain adjustments required as a result of a Section 338 election and the availability of certain tax credits to the acquired and acquiring corporations . . . , detailed information should be obtained from the temporary regulation (1.338[b][2])." The memorandum advised that:

> [g]enerally, New York State follows the federal treatment under Section 338. Therefore, for New York State tax purposes, the acquired corporation must file a cessation report to the date of liquidation. It is required to recapture any unearned investment tax credit and depreciation and recognize gain or loss in situations where the acquiring corporation does not purchase all of the stock of the acquired corporation. It then files subsequent reports as if it were a new corporation. It would then have a stepped up basis for the property and could claim an investment tax credit if the property otherwise qualifies.

The TSB-M made it clear that New York State would be following Federal policy as to ITC recapture with regard to a section 338 election, and that a taxpayer in petitioner's situation would be required to recapture the unearned ITC.

J. A tax credit is a particularized species of exemption from tax (***Matter of New York Fuel Corp.***, Tax Appeals Tribunal, August 27, 1998). Exemptions from tax must be strictly

construed, and "an exemption from taxation 'must clearly appear, and the party claiming it must be able to point to some provision of law plainly giving the exemption'" (***Matter of Grace v. State Tax Commn.***, 37 NY2d 193, 371 NYS2d 715, 718, ***lv denied*** 37 NY2d 708, 375 NYS2d 1027 quoting ***People ex rel. Savings Bank of New London v. Coleman***, 135 NY 231). Moreover, as the Tax Appeals Tribunal noted in its citing of ***Matter of Niagara Mohawk Power Corp. v. Wanamaker*** (286 App Div 446, 144 NYS2d 458, ***affd*** 2 NY2d 764, 157 NYS2d 972), the statutory language providing the exemption must be construed in a practical manner (***Matter of Qualex, Inc.***, Tax Appeals Tribunal, February 25, 1995).

Furthermore, the taxpayer must establish that its interpretation of the statute is not only plausible, but also that it is the only reasonable construction (***Matter of Blue Spruce Farms v. New York State Tax Commn.***, 99 AD2d 867, 472 NYS2d 744; ***affd for reasons stated below***, 64 NY2d 682, 485 NYS2d 526), and that the taxpayer must show that the Division's interpretation of the exemption's scope is irrational or clearly erroneous (***Matter of Great Lakes Dredge & Dock Co. v. Department of Taxation & Fin.***, 39 NY2d 75, 382 NYS2d 958, ***cert denied***, 429 US 832; ***Matter of Young v. Bragalini*** , 3 NY2d 602, 170 NYS2d 805, ***rearg denied*** 4 NY2d 879, 174 NYS2d 1027).

K. Petitioner's interpretation of the statute is inconsistent with the Federal policy dealing with the recapture of the ITC in situations involving section 338(h)(10) upon which the New York State ITC is based. In addition, petitioner has failed to carry its burden to establish that its interpretation of the statute is the only reasonable construction (***Matter of Blue Spruce Farms v. New York State Tax Commn.***, ***supra***) or that the Division's interpretation of the exemption's scope is irrational or clearly erroneous (***Matter of Great Lakes Dredge & Dock Co. v. Department of Taxation & Fin.***, ***supra***). More importantly, section 338(h)(10), although

structured as a stock sale, provides the taxpayer with the opportunity to treat such stock sale as an asset sale, with the acquiring corporation obtaining the assets with a stepped-up basis. The substance of the transfer is a sale of assets, and it is therefore appropriate to treat the transaction as a disposition of real property for purposes of Tax Law former § 210(12)(g) and to require recapture of the unearned ITC. Finally, it is noted that the new target corporation, following the section 338(h)(10) election, claimed the ITC on the assets involved at a stepped-up basis as of the date of the deemed sale. This treatment of the assets as having been "acquired" by sale is consistent with the conclusion that the property was "disposed" of at the time of the section 338 election, and is inconsistent with petitioner's argument that nothing changed in petitioner's operation and treatment of the assets at issue. Here, petitioner itself, by claiming an ITC at the stepped-up basis, has treated the election under section 338 as a sale of the real property at issue.

L. The Division assessed penalty against petitioner for substantial understatement of tax, pursuant to Tax Law § 1085(k). Petitioner maintains that, whether or not recapture is appropriate, all penalties should be waived based on a showing of reasonable cause and good faith by petitioner. Petitioner contends that its reporting position was not inconsistent with the Division's regulations (***see*** Conclusion of Law "C"), which identified specific examples of dispositions, but do not include a stock sale. Petitioner notes that although TSB-M-86(3)C did reflect the Division's policy on ITC recapture, such Technical Services Bureau Memorandum is 17 years old, and in that time the Division has not amended 20 NYCRR 5-2.8 to reflect that policy.

In response to the foregoing, the Division argues that good faith is absent because petitioner has failed to establish what efforts it made to ascertain its proper tax liability with respect to ITC recapture.

M. In addition to the reasonable cause standard, the Division's regulations concerning waiver of penalty for substantial underreporting provided for a waiver upon a showing of good faith by the taxpayer. Specifically, the former regulations provided, in pertinent part, that:

> (2) In determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability. In addition to any relevant grounds for reasonable cause as exemplified in subdivision (d) of this section, circumstances that indicate reasonable cause and good faith with respect to the substantial understatement of tax, where clearly established by or on behalf of the taxpayer, may include the following:
>
> (i) an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer;
>
> (ii) a computational or transcriptional error;
>
> (iii) the reliance by the taxpayer on any written information, professional advice or other facts, provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer on inquiry as to whether such facts were erroneous (20 NYCRR former 46.1[f][2]).

Under the facts of this case, petitioner has not shown that it acted in good faith as described in the Division's former regulations. As petitioner readily admits, the Division had published a Technical Services Bureau Memorandum (TSB-M-86[3]C) entitled "New York State Treatment of a § 338 Election" which advised taxpayers that the Division would follow Federal treatment of ITC recapture in analyzing recapture issues under New York State's parallel ITC provisions. As Fedral ITC recapture was triggered by a deemed asset sale under section 338(h)(10), petitioner was placed on notice of the Division's policy that recapture was required in the transaction at issue. Furthermore, Technical Services Bureau advisory opinions were issued in 1988, 1993 and 1998 which stated that, in effect, transfers pursuant to section 338 of the IRC constituted a disposition of real property thereby triggering ITC recapture. The Division adequately advised petitioner and other similarly situated taxpayers of its policy regarding ITC

recapture following an election under IRC § 338, and having been placed on notice of this policy, petitioner's claim of reasonable cause and good faith is rejected.

N. Petitioner correctly points out that Technical Service Bureau Memoranda are merely informational statements issued by the Division to disseminate current policies and guidelines and are advisory in nature, have no legal force or effect, are not binding and do not rise to the level of a promulgated rule or regulation. However, Technical Services Bureau Memoranda are statements of an informational nature issued to advise taxpayers of significant changes in the law, to disseminate the Division's interpretation of the Tax Law, and to notify the public of current audit policy and guidelines (***see,*** Developing and Communicating Interpretations of the Tax Laws: A Report to the Governor and the Legislature Reviewing Department of Taxation and Finance Policies and Practices, March 1989, at 20). As such, they clearly come within the exception of "forms and instructions, interpretative statements and statements of general policy which in themselves have no legal effect but are merely explanatory" specifically excluded from the formal promulgation requirements governing rulemaking by administrative agencies (State Administrative Procedure Act § 102[2][b][iv]; ***see, Matter of Hawkes v. Bennett***, 155 AD2d 766, 547 NYS2d 704; ***Leichter v. Barber***, 120 AD2d 776, 501 NYS2d 925). To be sure, because TSB-M-86(3)C does not meet the statutory notice and filing requirements, it cannot, in and of itself, purport to have any definitive legally binding effect. However, to the extent that the memorandum states a correct and straightforward interpretation of the governing statute, the Technical Services Bureau Memorandum constitutes an effective administrative vehicle for informing taxpayers of the position of the Division. The Division is not required to promulgate regulations regarding its treatment of ITC recapture where the taxpayer has made an election under IRC § 338 (***Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corp. v. Tax***

Appeals Tribunal, 185 AD2d 466, 585 NYS2d 867, ***lv denied*** 80 NY2d 761, 592 NYS2d 670; ***Matter of Reynolds, Bogoni, Kelly & Urich***, Tax Appeals Tribunal, March 9, 1995). The memorandum was an appropriate method to explain the Division's policy on the treatment of ITC recapture, and it adequately advised taxpayers of that policy. (***See***, ***Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corp.***, Tax Appeals Tribunal, December 28, 1990, ***confirmed***, ***supra***.)

O. As the Division has correctly pointed out, petitioner's reliance on ***Matter of Philip Morris*** (Tax Appeals Tribunal, November 2, 1995) to support its interpretation of Tax Law § 210(12)(g) is misplaced. The Tribunal in ***Philip Morris*** addressed the issue of whether an appraisal commissioned by the taxpayer accurately reflected the fair market value of real property transferred pursuant to a section 338 election, notwithstanding the figure reported on the taxpayer's Federal income tax returns. The Division in that case argued that the valuation of assets under section 338 was premised on fair market value and the taxpayer should, for gains tax purposes, be bound by the amount reported in its Federal returns, as that amount should be deemed to constitute fair market value. The Tribunal declared that it was "unwilling to conclude . . . that accounting treatment under the Internal Revenue Code is conclusive for New York State transfer gains tax purposes," and declined to "find controlling the fact that petitioner stated a different value for the subject property on its Federal income tax returns than was reported for gains tax purposes."

The ***Philip Morris*** holding centered on a narrow valuation issue in the context of transfer gains tax. The Tribunal held that a taxpayer's fictitious gain determined for a purpose unrelated to the transfer gains tax would not bind the taxpayer, particularly where the Division's own regulations specifically provided that a taxpayer for transfer gains tax purposes may determine

fair market value pursuant to an appraisal. In contrast, the issue herein concerns ITC recapture following a section 338 election, and centers on whether such election constitutes the disposition of real property. The position taken by the Division in ***Philip Morris*** is not controlling in the present matter.

P. The petition of AIL Systems, Inc. is denied, and the Notice of Deficiency issued October 21, 2002 is sustained.

DATED: Troy, New York
October 4, 2004

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE