STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of	:	
ZWEIG TOTAL RETURN ADVISORS, INC., ZWEIG ADVISORS, INC. AND PXP SECURITIES CORP.	:	DETERMINATION DTA NOS. 819390, 819391 AND 819392
for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Year Ended March 1, 1999.	:	

Petitioners, Zweig Total Return Advisors, Inc., Zweig Advisors, Inc., and PXP Securities Corp., c/o Michael Link, Zweig DiMenna, 900 Third Avenue, 31st Floor, New York, New York 10022, filed petitions for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal year ending March 1, 1999.

A consolidated hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on November 20, 2003 with all briefs to be filed by July 1, 2004, which date began the six-month period for the issuance of this determination. Petitioners appeared by Russell W. Banigan, CPA, and Matthew J. DiDonato, Esq. The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Kevin R. Law, Esq., of counsel).

ISSUE

Whether a New York State S corporation is required to include a gain from an Internal Revenue Code § 338(h)(10) transaction in the S corporation's entire net income for purposes of determining the S corporation's entire net income.

FINDINGS OF FACT

The facts in this matter have been stipulated by the parties. The pertinent facts are as follows:

1. Petitioner Zweig Advisors, Inc. ("Zweig Advisors") was incorporated under the laws of the State of Delaware on May 7, 1986. Petitioner Zweig Total Return Advisors, Inc. ("Zweig Total Return Advisors") was incorporated under the laws of the State of Delaware on June 27, 1988. Petitioner PXP Securities Corp., formerly known as Zweig Securities Corp., was incorporated under the laws of the State of Delaware on June 30, 1988.

2. Zweig Advisors and Zweig Total Return Advisors were registered investment advisors and provided investment advisory services to The Zweig Fund, a regulated investment company (mutual fund). PXP Securities Corp. was a securities broker and provided distribution services for the Zweig Series Trust and Euclid Mutual Funds.

3. Effective from the dates of their incorporation, Zweig Advisors and Zweig Total Return Advisors elected to be treated as S corporations for both Federal and State purposes. Effective January 1, 1990, PXP Securities Corp. elected to be treated as an S corporation for both Federal and New York State tax purposes.

4. Each petitioner's Federal and New York State S corporation status was in effect for the taxable year ended March 1, 1999.

5. On March 1, 1999, each petitioner's shareholders sold all of their shares of stock in petitioners to an unrelated party, Phoenix Investment Partners, Ltd. ("Buyer"). With respect to this sale of stock, the shareholders of each petitioner made an election under IRC § 338(h)(10) to treat the transaction for Federal income tax purposes as if each petitioner sold off all of its assets

to the Buyer, then liquidated and distributed the sales proceeds to the shareholders.

6. The section 338(h)(10) election was made on Federal form 8023, which was attached to the Federal S corporation return filed by each petitioner for the taxable year ended March 1, 1999.

7. A copy of each respective petitioner's Form 8023, as filed with the U.S. Internal Revenue Service, is included in the copy of each petitioner's Federal tax return, Form 1120S and related forms and schedules for the taxable period in question. In section G of each Form 8023 (which is entitled "Elections under section 338"), Line 12 provides as follows: "Check here to make a section 338(h)(10) election for the target corporation listed in Section B on page 1." The corresponding box for this election was checked.

8. In section G of Form 8023, Line 13 states "Check here to make a section 338 election (other than a section 338[h][10] election) for the target corporation listed in Section B on page 1." The corresponding box for this election was not checked.

Zweig Advisors, Inc.

9. The section 338(h)(10) transaction resulted in a Federal taxable gain to the shareholders of $31,448,001.00. This gain was reported on line 4e(2) of Schedule K of Form 1120S (the Federal S corporation return). In addition, line 4e(2) of each Form K-1 (entitled "Shareholder's Share of Income, Credits, Deductions, etc.") issued by Zweig Advisors to its shareholders for the taxable year ended March 1, 1999, reported the result of the gain multiplied by the particular shareholder's ownership interest in petitioner. The total of line 4e(2) for all the Forms K-1 (i.e., $31,448,001.00) included in the Federal return equals the gain reported on line 4e(2) of Schedule K of 1120S.

10. Zweig Advisors had 59 shareholders for the taxable year ended March 1, 1999, all of whom were individuals. Forty-two of Zweig Advisors' shareholders were residents of New York State. The three largest shareholders, Messrs. Martin Zweig, Joseph DiMenna and Eugene Glaser, in total owned 80.45% of Zweig Advisors for the taxable year ended March 1, 1999. Messrs. Zweig, DiMenna and Glaser were residents of New York State and New York City during the calendar year 1999 and collectively paid $2.7 million of New York State and New York City personal income taxes with respect to their shares of the IRC § 338(h)(10) gain.

Zweig Total Return Advisors

11. The section 338(h)(10) transaction resulted in a Federal taxable gain to Zweig Total Return Advisors' shareholders of $19,633,169.00. The gain was reported on line 4e(2) of Schedule K of Form 1120S (the Federal S Corporation return). In addition, line 4e(2) of Form K-1 (entitled "Shareholder's Share of Income, Credits, Deductions, etc.") issued by Zweig Total Return Advisors to its shareholders for the taxable year ended March 1, 1999, reported the result of the gain multiplied by the particular shareholder's ownership interest in petitioner. The total of line 4e(2) for all the Forms K-1 (i.e., $19,633,169.00) included in the Federal return equals the gain reported on line 4e(2) of Schedule K of Form 1120S.

12. Petitioner Zweig Total Return Advisors had 58 shareholders for the taxable year ended March 1, 1999, all of whom were individuals. Forty-three of the shareholders were residents of New York State. The three largest shareholders, Messrs. Martin Zweig, Joseph DiMenna and Eugene Glaser, in total owned 78.94% of Zweig Total Return Advisors for the taxable year ended March 1, 1999. Messrs. Zweig, DiMenna and Glaser collectively paid $1.65 million of New York State and New York City personal income taxes with respect to their shares

of IRC § 338(h)(10) gain.

PXP Securities Corp.

13. The section 338(h)(10) transaction resulted in a Federal taxable gain to the shareholders of $626,988.00 which was reported on line 4e(2) of Schedule K of PXP Securities Corp. Form 1120S (the Federal S corporation return). In addition, line 4e(2) of each Form K-1 (entitled "Shareholder's Share of Income, Credits, Deductions, etc.") issued by PXP Securities Corp. to its shareholders for the taxable year ended March 1, 1999, reported the result of the gain multiplied by the particular shareholder's ownership interest in PXP Securities Corp. The total of line 4e(2) for all the Forms K-1 (i.e., $626,988.00) included in the Federal return equals the gain reported on line 4e(2) of Schedule K of Form 1120S.

14. PXP Securities Corp. had two shareholders, Messrs. Martin Zweig and Eugene Glaser, for the taxable year ended March 1, 1999. Each of the shareholders were individuals who were residents of New York State and New York City during the calendar year 1999. Collectively, the shareholders paid $65,000.00 of New York State and New York City personal income taxes with respect to their shares of the IRC § 338(h)(10) gain.

The Audit

15. The Division of Taxation ("Division") reviewed the tax return of each petitioner as well as the New York State resident income tax returns of Messrs. Zweig, DiMenna and Glaser. The Division concluded that Messrs. Zweig, DiMenna and Glaser properly accounted for their respective shares of the gain generated from the IRC § 338(h)(10) transaction. Refunds would not be due to any of the shareholders of petitioners based on the findings of the Division of Tax Appeals in this matter because the treatment of the deemed asset sale for Article 9-A tax

purposes does not alter the Article 22 tax treatment applied to petitioners' shareholders. Specifically, the shareholders of each petitioner would include the gain from the IRC § 338(h)(10) transaction in their calculation of New York adjusted gross income to the extent that such gain should be included in their Federal adjusted gross income.

16. No Federal income tax was assessed against petitioners with respect to the IRC § 338(h)(10) transaction.

17. With respect to their New York State S corporation returns for the taxable year ended March 1, 1999, petitioners took the position that no New York State corporate level tax was owed with respect to the IRC § 338(h)(10) transaction. Petitioners' position was based upon the Tax Law § 208(9)(ii) requirement that a New York S corporation's entire net income is determined as if the S corporation was a C corporation for Federal purposes. According to petitioners, under applicable Federal regulations governing IRC § 338(h)(10) elections, shareholders of a C corporation cannot make an IRC § 338(h)(10) election with respect to that target corporation unless the target corporation is a member of an affiliated group or consolidated return group. Petitioners then allege, as the Federal regulations specify, that if an IRC § 338 (h)(10) transaction is invalid, then all of IRC § 338 is invalid with respect to that transaction.

18. None of the petitioners is a member of an affiliated group or consolidated return group, as defined for purposes of the Internal Revenue Code.

19. Several auditors from the Division reviewed petitioners' returns for the year in issue and concluded, on the basis of the New York State Advisory Opinion entitled ***Arnold Haskell*** (TSB-A-97[5]C), that the gain generated by the IRC § 338(h)(10) transaction should be included

in petitioners' entire net income. Petitioners objected to the imposition of the entity-level tax under Article 9-A, based on the view that ***Arnold Haskell*** was incorrectly based on Federal temporary regulations governing IRC § 338(h)(10) transactions that were no longer in effect for taxable years beginning after 1993. Petitioners' representative, Russell W. Banigan of Deloitte & Touche LLP ("D & T"), met with the Division's auditors and asked that any deficiency notice be delayed until D & T could seek reconsideration of the ***Arnold Haskell*** Advisory Opinion by the Division. The Division's auditors agreed to the delay.

20. On March 9, 2001, Mr. Banigan, on behalf of petitioners, submitted a petition for an advisory opinion (the "request") from the Division regarding petitioners' contention that IRC § 338 be considered inapplicable in determining the entire net income of a Federal S corporation that is the target corporation in an IRC § 338(h)(10) transaction for purposes of the Article 9-A tax for the final return of "Old Target Corporation."

21. Subsequent to the request for an advisory opinion, Mr. Banigan advised the Division that petitioners would withdraw the advisory opinion request and seek to have the matter reviewed by the Division of Tax Appeals. On August 29, 2002, Mr. Banigan received formal confirmation from the Technical Services Division concerning the withdrawal of the request for an advisory opinion. In September 2002, Mr. Banigan advised the audit team leader that the advisory opinion request had been withdrawn.

22. On October 16, 2002, the Division of Taxation issued a series of letters to D & T with an attached Consent to Field Audit Adjustment Notice. The letter issued to Zweig Total Return Advisors, Inc. stated that tax of $153,377.00 plus interest of $48,120.00 was due to New York State. The letter issued to Zweig Advisors, Inc. stated that tax of $260,874.00 plus interest of

$81,845.00 was due to New York State. The letter issued to PXP Securities Corp. stated that tax of $905.00 plus interest of $284.00 was due to New York State.

23. On behalf of the petitioners, Mr. Banigan reiterated that petitioners would seek review of the matter by the Division of Tax Appeals and stated that the Division of Taxation should proceed with issuing a notice of deficiency.

24. The Division issued a series of notices of deficiency dated November 15, 2002 as follows: the Division issued a notice to Zweig Total Return Advisors, Inc., assessment number L-021785331-6, which asserted that corporation franchise tax was due in the amount of $153,377.00 plus interest in the amount of $48,717.04 for a balance due of $202,094.04; the Division issued a notice to Zweig Advisors, Inc., assessment number L-021785330-7, which asserted that corporation franchise tax was due in the amount of $260,874.00 plus interest in the amount of $82,860.49 for a balance due of $343,734.49; and the Division issued a notice to PXP Securities Corp., assessment number L-021785332-5, which asserted that corporation franchise tax was due in the amount of $905.00 plus interest in the amount of $287.52 for a balance due of $1,192.52.

CONCLUSIONS OF LAW

A. During the year in issue, a New York State subchapter S corporation was subject to tax on the higher of the tax that would be computed by a C corporation on its entire net income base or the fixed dollar minimum reduced by the "article twenty-two tax equivalent" but not less than the fixed dollar minimum (Tax Law § 210[1][g]).

B. Each petitioner is a Federal and New York State S corporation whose shareholders sold all of their stock. The shareholders of each petitioner and the buyer made an election under IRC

§ 338(h)(10) to treat the transaction for Federal income tax purposes as if each respective petitioner sold all of its assets to a new corporation and then liquidated.

C. For background, in a transaction involving IRC § 338(a) there is the sale of stock of a corporation. However, for tax purposes a legal fiction is created. The purchaser, in a qualified stock purchase, may make an election whereby the target corporation (old target) is treated as having sold all of its assets as of a certain date and then treated as a new corporation (new target) which purchased all of the assets as of a certain date. As a result of the election, the old target recognizes gain or loss on the difference between the fair market value of the assets and the adjusted basis of the assets. The basis of the assets is stepped up or down as appropriate. The selling shareholders recognize gain or loss on the disposition of their stock.

If an election is made under IRC § 338(a), the seller and purchaser of the target stock may make an additional election under Tax Law § 338(h). Under this election, the target is deemed to have sold all of its assets and distributed the proceeds in a complete liquidation. As a result, the sale of the target stock in the qualified stock purchase usually is ignored. This election may be made only if the target is a member of a selling consolidated or affiliated group or an S corporation. The gain or loss on the deemed asset sale is included in the tax return of the selling consolidated or affiliated group or S corporation shareholders, but no gain or loss is recognized on the sale of the target stock. Under Treasury Regulations promulgated in 1994, if a section 338(h)(10) election is invalid, the entire section 338 election is invalid (Treas Reg § 1.338[h][10]-1[d][4]).

D. The issue in this case involves the proper interpretation of Tax Law § 208(9). During the period in issue, this section provided in pertinent part:

> The term "entire net income" means total net income from all sources, which shall be presumably the same as the entire taxable income (but not alternative minimum taxable income),
>
> (i) which the taxpayer is required to report to the United States treasury department, or
>
> (ii) which the taxpayer would have been required to report to the United States treasury department if it had not made an election under subchapter s of chapter one of the internal revenue code, or
>
> (iii) which the taxpayer, in the case of a corporation which is exempt from federal income tax (other than the tax on unrelated business income imposed under section 511 of the internal revenue code) but which is subject to tax under this article, would have been required to report to the United States treasury department but for such exemption. . . .

E. In essence, petitioners argue that since clause (ii) of Tax Law § 208(9) requires a corporation to compute its entire net income as if it had not made a subchapter S election, the gain from the deemed asset sale is not included because a section 338(h)(10) election is not available to a C corporation under the facts presented here. Petitioners also rely on the previously mentioned Federal rule that an invalid section 338(h)(10) election means that no portion of section 338 is applicable. Consequently, petitioners submit that any gain resulting from a section 338(h)(10) transaction is not included in the entire net income of the New York S corporation for purposes of determining its New York State franchise tax under Article 9-A of the Tax Law.

F. The Division submits that petitioners err by constraining their analysis to clause (ii) of Tax Law § 208(9). Focusing upon clause (i), which provides that entire net income is presumably the same as the entire net income which the taxpayer is required to report to the United States Treasury Department, the Division notes that petitioners were required to report the gain on the deemed asset sale to the United States Treasury on their respective form 1120S

schedule D. Accordingly, the Division maintains that the plain letter of the law supports the Division's notices.

G. The Division's argument is rejected because it does not comport with the plain language of the controlling statute. The use of the word "or" at the end of clauses (i) and (ii) indicates the presence of alternatives, that is, "an alternative between different or unlike things . . ." (Webster's Third New International Dictionary, 1986). Here, as petitioners' representative notes, it is clear that the Legislature provided for three alternatives: clause (i) for situations involving Federal C corporations, clause (ii) for situations involving Federal S corporations and clause (iii) for corporations that come within the Federal exemption from taxation but are not exempt from New York State taxation. If the Division's position were accepted, it would render the second clause of Tax Law § 208(9) superfluous.[1]

H. In its brief, the Division argues that clause (ii) of Tax Law § 208(9) was intended as a "stand-still" directive and that "the provision was intended merely as a mechanism to reconsolidate the separately stated items and income of each S shareholder to arrive at entire net income." (Division's brief, p. 12.) The Division submits that the legislative intent manifests itself through Tax Law § 208(9)(f)(3) which permits an S corporation to claim a net operating loss deduction for New York State franchise tax purposes. According to the Division, if one adopted petitioners' position, Tax Law § 208(9)(f)(3) would be superfluous because Federal C corporations are specifically allowed net operating loss deductions.

I. There are a number of difficulties with the Division's analysis. Perhaps the most

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[1] Petitioners have accurately pointed out that, over a period of a number of years, the Division has consistently taken the position that in computing the taxable income of a Federal S corporation, clause (ii) of Tax Law § 208(9) is the operative clause (***Compare H.W. Wolding, Inc.,*** Advisory Opinion, TSB-A-98[14]C, ***with*** "***1990 Legislation - Franchise Tax on New York S Corporations***," TSB-M-90[11])C).

significant difficulty is that it is inconsistent with the plain language of clause (ii) of Tax Law § 208(9). As noted by petitioners' representative, if the reconsolidation theory were correct, then the Division would not ask an S corporation to attach a pro forma Form 1120 to the S corporation's New York State return. The Division would merely direct S corporations to determine line one of the New York State form CT-3S by determining the net effect of the items of income, deduction, gain, or loss reported on the S corporation's Federal Schedule K.

J. The Division's argument that accepting petitioners' position renders Tax Law § 208(9)(f)(3) superfluous is also specious. As noted in footnote 1, the Division has consistently taken the position that clause (ii) of Tax Law § 208(9) is the operative clause in determining the entire net income of an S corporation. Further, prior to the enactment of Tax Law § 208(9)(f)(3), the Division maintained that Federal S corporations were not entitled to a net operating loss deduction (***see, e.g.***, TSB-M-81[11]).

K. The Division argues that its interpretation of the law results in a "consistent basis adjustment" and in "transactional parity" between the S corporation and its shareholders by requiring the S corporation to include the gain realized from the deemed asset sale under IRC § 338(h)(10). In response, petitioners argue that neither concept has been incorporated into New York State Tax Law. Regardless of the public policy considerations which may support the Division's interpretation, it is clear that such principles may not defeat the clear language of the statute which controls the outcome of this matter. Further, the conclusion presented here has the benefit of maintaining a consistent interpretation between Tax Law § 208(9) and comparable language found in section 11-602.8 of the Administrative Code of the City of New York (***see***, New York City Rule 11-27[j]).

L. In the alternative, the Division argues that section 211(5) of the Tax Law allows the Commissioner to adjust petitioners' entire net income to include the gain from the deemed asset sale in each petitioner's entire net income. Petitioners' brief has accurately pointed out that Tax Law § 211(5) allows the Division of Taxation to adjust items of income and deduction where the taxpayer's entire net income is improperly stated as a result of an arrangement with some other corporation, person or firm. The Division is also permitted to make adjustments where the taxpayer has shifted income and deductions between itself and a person having some type of ownership interest in the taxpayer. Neither of these situations is applicable. The Division is not invested with the authority to recognize an item of income that is not otherwise recognized under New York law. Therefore, this argument is also rejected.

M. It is noted that petitioners have presented arguments regarding the accuracy of ***Arnold Haskell*** (Advisory Opinion, TSB-A-97[5]C). The auditors cited this Advisory Opinion as their rationale for the proposed assessments. These arguments have not been addressed since the correctness of this advisory opinion is not determinative of the outcome of the case.

N. The petitions of Zweig Total Return Advisors, Inc., Zweig Advisors, Inc. and PXP Securities Corp. are granted and the notices of determination, dated November 15, 2002, are canceled.

DATED: Troy, New York
December 16, 2004

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE