REPORT #774

TAX SECTION

New York State Bar Association

REPORT ON DEFINITION OF SUBSIDIARY
UNDER NEW YORK STATE TAX LAW

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TAX SECTION

New York State Bar Association

October 22, 1993

Via Federal Express

Hon. James W. Wetzler
Commissioner of Taxation and Finance
State Campus - Building No. 9
Albany, New York 12227

Dear Commissioner Wetzler:

As we discussed, I am enclosing the Tax Section's report on the definition of the term "subsidiary" under the New York State tax law. It deals with the proposed regulation issued by the Department of Taxation and Finance in the wake of the Racal case. I hope you find it to be of assistance in finalizing the regulation.

Please call me with any comments.

Yours truly,

Peter C. Cane11os

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON STATE AND LOCAL TAXES

REPORT ON DEFINITION OF SUBSIDIARY UNDER NEW YORK STATE TAX LAW[*/]

1. Introduction.

The New York State Department of Taxation and Finance ("Department") has issued proposed regulations to redefine the term "subsidiary" for purposes of the New York State Tax Law. Section 208.3 of the New York Tax Law defines subsidiary as "a corporation of which over fifty percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer.[1/] The current regulations elaborate on this definition by stating that the term subsidiary means "a corporation which is controlled by the taxpayer, by reason of the taxpayer's ownership of more than fifty percent (50%) of the total number of the shares of stock of such corporation, issued and outstanding, which entitle the holder of the shares to vote at elections of its directors or trustees." 20 NYCRR § 3-6.2(a). Moreover, the regulations define

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*/ This report was prepared by the Committee on State and Local Taxes, Arthur R. Rosen and Sterling L. Weaver, co-chairs. The principal author of the report is Brian Kopp. Helpful comments were received from John R. McQueen, Michael Schler and Carolyn Lee. Some members of the Committee are handling matters before the Tax Appeals Tribunal or in the administrative process which might be affected by the proposed regulation change.

1/ Article 32 which addresses the franchise tax on banking corporations defines subsidiary similarly. New York Tax Law § 1450(d).

the test of ownership as "actual beneficial ownership, rather than mere record title as shown by the stock books of the issuing corporation." 20 NYCRR § 3-6.2(b)(emphasis added). In Matter of Racal Corporation and Decca Electronics, Inc., 93-2 NYTC T-458 (May 13, 1993), the Tax Appeals Tribunal stated that beneficial ownership is "marked by command over property or enjoyment of its economic benefits" and concluded the taxpayer's second tier corporation was a "subsidiary" for purposes of the New York Tax Law.

Under the proposed regulations, the Department seeks to overrule the Tribunal's decision in Racal by redefining the term "subsidiary." Specifically, the Department is proposing to change the definition of subsidiary to state that "[a]ctual beneficial ownership of stock does not mean indirect ownership or control of a corporation through a corporate structure consisting of several tiers and/or chains." Proposed Regulations § 3-6.2(b). Thus, under the proposed regulations, a taxpayer's second tier corporation will not constitute a subsidiary for purposes of the New York State Tax Law.

The current statutory definition of subsidiary is silent as to whether a taxpayer's indirect ownership of a corporation's stock should be considered in determining whether a corporation qualifies as a subsidiary (e.g., whether the stock held by a taxpayer's wholly-owned first tier corporation can be attributed to the taxpayer). The proposed regulations are intended to clarify this ambiguity. Moreover, they constitute a reasonable interpretation of the statutory definition of "subsidiary". Therefore, the Committee does not oppose the proposed regulations. Consistent with their objective, the proposed regulations define "subsidiary" in a manner which contradicts the current regulations as interpreted in Racal. The Tax Appeals Tribunal interpreted these regulations to permit a taxpayer to treat its second tier corporation as a subsidiary for purposes of the New York Tax Law. Because the proposed regulations change current law, the Committee believes that the proposed regulations, if adopted, should apply prospectively only and should not be applied to years prior to 1994. Additionally, the Committee believes that the Department should clarify the definition of ownership to give taxpayers better guidance as to how this term will be interpreted.

2. Proposed Regulations.

As discussed above, the statute is ambiguous as to whether a taxpayer must have direct ownership of a corporation's voting stock for the corporation to be treated as a subsidiary for purposes of Articles 9-A and 32 of the New York Tax Law. Reasonable arguments can be made both for and against the proposed regulations.

There are at least three reasons for adopting the proposed regulations. First, based on previous State Tax Commission decisions[2/] and the statutory definition which defines

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2/ See, Matter of Texas Instruments. Inc., TSB-H-80(23)C; Matter of Sears Industries, Inc., TSB-H-85(33)C; and Matter of Armour & Company, TSB-H-85(12)C.

subsidiary based on the stock "owned by the taxpayer"[3] many taxpayers have interpreted the definition of subsidiary to require direct ownership. Therefore, the proposed regulations would not detrimentally impact many taxpayers as it codifies what they thought the law to be. Second, the proposed regulations provide taxpayers a bright line test to determine whether or not a corporation qualifies as a subsidiary. From an administrative perspective, this bright line test is helpful as it allows taxpayers to calculate their New York State tax liability with greater certainty than is possible under the current regulations. Third, given the ambiguity of the statute, the proposed regulations are a reasonable interpretation of the definition of subsidiary.

There are also several reasons for not adopting the proposed regulations. First, the proposed regulations are inconsistent with the commonly understood definition of a subsidiary as set forth in accounting principles, SEC reporting requirements and other areas of the law. Generally, these areas of the law define subsidiary based on the direct or indirect

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3/ In contrast to the definition of subsidiary under New York Tax Law section 208.3 which does not qualify the word "owned" with "directly or indirectly", other provisions of the New York Tax Law have specifically qualified the word "owned" with "directly or indirectly". See e.g., New York Tax Law §§ 211.4, 1452(a)(9). Because the term "directly or indirectly" was not used to qualify the word "owned", many taxpayers assumed that only direct ownership should be considered when determining whether a corporation qualified as a subsidiary. In Racal, the Department made a similar argument which was rejected by the Tax Appeals Tribunal as being inconsistent with the regulations. Specifically, the Tribunal stated, "the [Department's] argument applies with equal force to those circumstances that the [Department] acknowledges are within the definition of beneficial ownership, e.g., where there has been a transfer of stock without legal title or a transfer to a trustee. Therefore, to accept the [Department's] argument would require us to find the entire regulation establishing beneficial ownership as the test of ownership is invalid." Racal, at T-467.

ownership of greater than 50% of a corporation's voting stock.[4/] Second, the proposed regulations emphasize form over substance. Most parent corporations view first tier and lower tier corporations similarly; however, the proposed regulations create an artificial distinction by treating first tier and lower tier corporations differently. Third, as discussed below, the legislative history of Article 9-A suggests that the term “subsidiary” was intended to include both first tier corporations and lower tier corporations.

Prior to amendments enacted in 1944, every corporation was categorized for New York franchise tax purposes as being either (i) a business corporation; (ii) an investment trust; or (iii) a holding corporation and each type of corporation was taxed differently on all of its income. The legislative history to the 1944 amendments indicates that the amendments were designed to preserve the distinction between the taxation of business corporations, investment corporations and holding corporations, while integrating them into a single tax system and taxing income according to the type of income rather than the type of corporation. State Tax Commission and Advisory Group, New York Taxes on Business Corporations, Investment Trusts and Holding Corporations - Report to Honorable Thomas E. Dewey. Governor p/7,8 (Nov. 12, 1943). Prior to 1944, a holding company was defined as a company “whose sole business consists of the holding of stocks of other corporations for the purpose of controlling the management and affairs of such other

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[4/] See e.g., Accounting Principles Bulletin 18; 17 CFR § 210.1-02 (SEC defines subsidiary in terms of the direct or indirect control over another corporation); See also, TSB-M-79(1)C (Rev. October 19, 1979) which was cited in the Racal decision (under Article 32, stockholder has beneficial ownership when it owns indirectly and controls the voting stock of another corporation).

corporations." New York Tax Law § 188 (repealed 1944). Under this definition, the distinction between first tier and lower tier corporations appears to be irrelevant. Therefore, the proposed regulations are arguably inconsistent with the purpose of the 1944 amendments in that they go beyond merely integrating the prior taxation of holding companies into an unified tax system by defining subsidiary to exclude second and lower tier corporations even though the definition of a holding company under pre-1944 law appears to include such corporations.

As the above discussion suggests, reasonable arguments can be made both for and against adopting the proposed regulations. However, on balance, the proposed regulations appear to be a reasonable interpretation of an ambiguous statutory definition. Therefore, the Committee does not oppose the adoption of the proposed regulations on a prospective basis.

3. Retroactivity Issue.

If the Department decides to adopt the proposed regulations, the regulations should only be applied prospectively and should be given no retroactive effect. Thus, taxpayers who treated indirectly owned entities as subsidiaries should not face retroactive challenge under the proposed regulations. We understand that the Department intends to apply the proposed regulations prospectively only.

In its Regulatory Impact Statement, the Department asserts that the proposed regulation represents its "long-standing" position that a second (or lower) tier corporation is not a subsidiary under Articles 9-A or 32 of the Tax Law. This assertion may not be entirely accurate. As pointed out by the Tax Appeals Tribunal in Racal, in previous litigation the Department took the position that whether a second tier corporation was a subsidiary was a question of fact, not of law, and therefore it was inappropriate for the taxpayer to seek a declaratory judgment to challenge an adverse tax determination. Xerox Corp. v. Department of Taxation and Finance, 140 A.D.2d 945 (4th Dept. 1988), appeal denied, 72 N.Y.2d 809 (1988). Moreover, the proposed regulations reverse the Department's published interpretation of "beneficial ownership" under Article 32. Specifically, in TSB-M-79(1)C (Rev. October 19, 1979), the Department stated that beneficial ownership occurs when a corporation indirectly owns and controls the stock of another corporation. The Department's inconsistent position on this issue is all the more reason for applying the proposed regulations prospectively. Additionally, some taxpayers have relied on the current regulations to support their treatment of second' tier corporations as subsidiaries for purposes of the New York Tax Law. Moreover, the Tax Appeals Tribunal in Racal has concluded that a second tier corporation could be treated as a subsidiary under the current regulations. Taxpayers who have relied on the current regulations as interpreted in Racal should not have their tax positions undermined by the retroactive adoption of new regulations. See e.g., Matter of Newchannels Corporation, Tax Appeals Tribunal (September 23, 1993)(Department should not retroactively apply new principle of law when retroactive application would result in inequitable hardship to taxpayers); Howard Johnson Co. v. State Tax Commission, 65 N.Y.2d 726 (1985)(Department should not retroactively change its interpretation of a statutory provision); Linsley v. Gallman, 38 A.D.2d 367 (3rd Dept. 1972), aff'd, 33 N.Y.2d 863 (1973).

By the same token, however, the Committee does not believe that the Department should challenge taxpayers who took a position consistent with the proposed regulations in years prior to 1994. Many taxpayers relied on the decisions rendered by the State Tax Commission[5/] which held the second and lower tier corporations were not subsidiaries for purposes of the New York Tax Law and planned their tax affairs accordingly. These taxpayers should not be penalized for their justifiable reliance on State Tax Commission decisions, which are codified in the proposed regulations, and the Department should make it clear that it does not intend to apply the Racal decision in its audits of tax years prior to 1994. See, Matter of Newchannels Corporation, Tax Appeals Tribunal (September 23, 1993) (Department should not retroactively apply new principle of law when retroactive application would result in inequitable hardship to taxpayers).

4. Beneficial Ownership

The proposed regulations state:

> "The test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock books of the issuing corporation. Actual beneficial ownership of stock does not mean indirect ownership or control of a corporation through a corporate structure consisting of several tiers and/or chains." (Emphasis added).

Thus, the proposed regulations define ownership based on actual, direct "beneficial ownership." The concept of beneficial ownership is ambiguous as it has been given a broad range of interpretations under New York State and federal law. Therefore, the term "beneficial" should be dropped from the regulations but examples should be included demonstrating what arrangements (other than outright title to shares) constitute "ownership" for this purpose.

[5/] See footnote 2

The concept of beneficial ownership has arisen in a variety of different contexts under New York and federal law. For example, in TSB-M-79(1)C (Rev. October 19, 1979), the Department defined beneficial ownership as including both direct and indirect ownership and control. Specifically, the Department set forth a definition for "beneficial ownership" when discussing which taxpayers were treated as banking corporations under Article 32. Prior to 1985, banking corporations subject to such tax included:

> Any corporation eighty percent or more of whose voting stock is <u>beneficially owned</u> by a corporation or corporations subject to article three-a of the banking law ....

New York Tax Law § 1452(a)(8) (McKinney's 1975 & Supp. 1988) (emphasis added). In addressing which taxpayers would qualify as banking corporations under section 1452(a)(8) and taxable under Article 32, the Department, in TSB-M-79(1)C, concluded:

> Voting stock is beneficially owned when a corporation has actual or beneficial ownership of the voting stock of another corporation. The stockholder has actual ownership when it has the right to vote for the election of directors and the right to receive dividends. <u>The stockholder has beneficial ownership when it owns indirectly and controls the voting stock of another corporation</u> [.] . . . [Emphasis added.]
>
> The term "control" refers to all cases where one corporation or association possesses, directly or indirectly, the power to direct or cause the direction of the management and policies of another corporation or association, whether through the ownership of voting stock of such corporation or association or the ownership of voting stock of any corporation or association which possesses such power.

Thus, under TSB-M-79(1)C, the Department interpreted beneficial ownership to include the direct or indirect control over the voting stock of another company.

A similar interpretation of beneficial ownership is set forth under the New York real property transfer tax and transfer gains tax laws. Specifically, transfers of real property are exempt from transfer taxes and transfer gains taxes if the conveyances effectuate “a mere change of identity or form of ownership or organization where there is no change in beneficial ownership.” New York Tax Law § 1405(b)(6); see also, New York Tax Law § 1443.5. The regulations interpret this statutory provision to include transfers of real property by a corporation to its wholly owned subsidiary. Specifically, the transfer tax regulations provide that such a “conveyance is not taxable as there is no change in beneficial ownership.” 20 NYCRR § 575.10(c). Thus, under the transfer tax and transfer gains tax, a parent corporation is considered the “beneficial owner” of the real property of its wholly owned subsidiary.

The concept of beneficial ownership also pervades trust law. Under trust law, the beneficiary of a trust is considered to be the beneficial or equitable owner of stock held by the trust even though the beneficiary may not have the right to vote, sell or receive dividends from the stock. A trust is defined as “a fiduciary relationship with respect to property, subjecting the person by whom the title to property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.” 1 Scott on Trusts § 2.3 (1987 4th Ed.). When property is contributed to a trust, there is a separation between the legal and equitable interest in the property. In general, legal title to the property vests in the trustee, but equitable rights in the property vest in the trust beneficiary. The beneficiary is said to be the equitable or beneficial owner of the property held by the trust because the trustee has a fiduciary obligation to act solely in the best interests of the beneficiary when making decisions with respect to trust property. Therefore, under trust law, a beneficiary is the beneficial owner of stock held by the trust even though he may not have the right to vote, sell, or receive dividends from the stock.

The federal tax law has also addressed the concept of beneficial ownership as “ownership” in a variety of contexts. For purposes of the consolidated return rules, a corporation is treated as the “owner” of stock when it has the benefits and burdens of ownership (such as voting rights, dividend rights and risk of loss) even though the corporation may not have legal title to the stock. Under the federal consolidated return rules, a corporation is treated as a member of an affiliated group if a certain percentage of the corporation's stock is owned directly by members of the affiliated group. There is authority discussing the scope of the concept of beneficial ownership as “ownership” for this purpose. For example, in Revenue Ruling 55¬458, 1955-2 C.B. 579, Acquiring Corp. purchased all of the stock of Target Corp. and under the purchase agreement all of the Target Corp. stock was placed in the name of an escrow agent as security for the purchase price. Under the escrow arrangement, Acquiring Corp. had all rights in the ownership of the Target stock including voting and dividend rights. Under these facts, the IRS concluded that Acquiring Corp. was the beneficial owner of the Target Corp. stock and therefore Target Corp. could be included in Acquiring Corp.'s affiliated group for purposes of filing a consolidated return.

Likewise, in Revenue Ruling 84-79, 1981 C.B. 190, Parent Corp. transferred 75% of the voting stock of its wholly owned subsidiary to a revocable trust to comply with certain FAA requirements. Under the trust agreement, Parent Corp. had the right to receive dividends directly from the subsidiary, to terminate the trust at any time, and to appoint a new trustee without cause. Subject to certain restrictions, the trustee had the right to vote the subsidiary stock held by the trust. Under these facts, the IRS concluded that Parent Corp. was the beneficial owner of the subsidiary stock. See also, Revenue Ruling 70-469, 1970-2 C.B. 179 (corporation was beneficial owner of stock held by nominee when corporation had the right to receive the stock on demand); Miami National Bank v. Commissioner, 67 T.C. 793 (1977) (taxpayer was the beneficial owner of stock held in subordinated securities account). Therefore, for purposes of the consolidated return regulations, in determining whether a corporation is the beneficial owner of stock, the IRS and courts will consider such factors as whether the corporation has the right to vote the stock, the right to receive dividends, the economic risk of loss, the right to sell the stock, etc. The position of the IRS in applying these factors has been neither clear nor consistent over time. See, Crestol, Hennessy and Rua, The Consolidated Tax Return, at pp. 2-12-2-16 (1988).

The federal tax law has discussed the concept of beneficial ownership in a number of other contexts. For example, in Yelencsics v. Commissioner, 74 T.C. 1513 (1980), the Tax Court addressed the issue of whether a sale of stock had occurred. The court stated that for purposes of federal taxation a sale occurs upon the transfer of sufficient incidents of beneficial ownership which is marked by “command over property or enjoyment of its economic benefit.” Yelencsics, 74 T.C. at 1527. In concluding that a sale had taken place, the court looked to the transfer of such indicia of ownership as the right to vote the stock, the right to control the board of directors, the right to participate in the profits of the business, the right to dividends and the risk of loss. See also, Pacific Coast Music Jobbers, Inc. v.

Commissioner, 55 T.C. 866 (1971), aff'd, 457 F.2d 1165 (5th Cir. 1972) (sale occurs when benefits and burdens of ownership pass).

In Revenue Ruling 82-150, 1982-2 C.B. 110, the IRS addressed the issue of whether a taxpayer should be treated as the actual owner of stock for purposes of the foreign personal holding company rules. Under these rules, a taxpayer was deemed to be the actual owner of stock when he had the option to buy the stock and the option price was substantially less than the stock's fair market value. Under section 552(a) of the Code a corporation is treated as foreign personal holding company, if certain tests are met. One of these tests is that more than 50% of the outstanding stock of the corporation is owned directly or indirectly by five or less individuals who are U.S. citizens or residents. The taxpayer paid $70,000 for on option to purchase all of the stock of a foreign corporation with an option price of $30,000. The IRS concluded that the taxpayer has assumed the benefits and burdens of ownership of the foreign company's stock and should be treated as the actual owner of the stock.

As the above discussion indicates, the concept of beneficial ownership has been interpreted in a variety of different contexts to have different meanings. For example, under New York Tax Law, beneficial ownership has been interpreted to include indirect ownership through intermediary companies. Under trust principles, a beneficiary is considered the beneficial ownership of stock held by a trustee even though the beneficiary may not have the right to vote, sell or receive dividends from the stock. Under federal tax law, the IRS and courts have looked at such factors as the right to receive dividends, vote and sell the stock to determine who is the beneficial owner of the stock. Additionally, in certain contexts, the federal tax law treats holders of stock options as stock owners.

Because the concept of beneficial ownership is ambiguous and has been interpreted in a manner which is inconsistent with the meaning intended by the Department, the Department should consider eliminating the concept of “beneficial” ownership from the regulations and providing, instead, more detailed guidance as to how the Department will interpret the concept of ownership. It would be helpful to list in the regulation the ownership arrangements which, in addition to outright direct ownership, would qualify as ownership for this purpose. Presumably, the Department would like to apply a definition similar to that used for purposes of the consolidated return regulations. See e.g., Proposed Regulations § 3-6.2(b), Example 2. If this is the approach the Department would like to take, the Committee suggests that the regulations specifically set forth which indicia of ownership the Department will consider in determining if a taxpayer is the actual owner of stock (e.g., the right to receive dividends, the right to vote the stock, the right to sell or pledge the stock, the risk of loss, the right to receive distributions upon corporate liquidation, etc.). Such a list will give better guidance to taxpayers and eliminate much of the uncertainty that currently exists.

5. Summary

The current statutory definition of subsidiary is silent as to whether a taxpayer's indirect ownership of a corporation's stock should be considered in determining if the corporation qualifies as a subsidiary. The proposed regulations are intended to clarify this ambiguity and constitute a reasonable interpretation of the statutory definition of “subsidiary”. Therefore, the Committee does not oppose the proposed regulations. However, the proposed regulations define “subsidiary” in a manner which directly contradicts the current regulations as recently interpreted by the Tax Appeals Tribunal. Therefore, the Committee believes that the regulations, if adopted, should be applied on a prospective basis only, and should not be given any retroactive effect. Furthermore, the Committee believes that taxpayers who have treated second or lower tier corporations as subsidiaries consistent with current regulations should not have such treatment disturbed for years prior to the effective date of the proposed regulations. Additionally, the Committee believes that the Department should clarify the definition of ownership in the regulations to give taxpayers better guidance as to how this term will be interpreted.