STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
AIL SYSTEMS, INC.	:	DECISION 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 an exception to the determination of the Administrative Law Judge issued on October 4, 2004. Petitioner appeared by Morrison & Foerster LLP (Paul H. Frankel, Esq. and Irwin M. Slomka, Esq., of counsel). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Kathleen D. O'Connell, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition and petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on November 9, 2005 in New York, New York.

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

ISSUES

I. Whether petitioner's investment tax credit is recaptured as a result of an election pursuant to section 338 of the Internal Revenue Code of 1986, as amended.

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

FINDINGS OF FACT

Petitioner presented the testimony of four witnesses at the hearing before the Administrative Law Judge. One of the witnesses was presented as an expert in economics and another was presented as an expert in tax policy. Both submitted written reports. The Administrative Law Judge found that the information provided by these witnesses constituted arguments for an interpretation of the statute in question and accepted it in the record as "the equivalent of a memorandum of law or an argument on the law" rather than as part of the factual record (Hearing Tr., pp. 65-68, 112). We follow and adopt the determination of the Administrative Law Judge in this regard.

We find the facts as determined by the Administrative Law Judge and make additional findings of fact. The Administrative Law Judge's findings of fact and the additional findings of fact are set forth below.

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

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

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").

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

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.

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.

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.

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.

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

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").

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").

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.

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.

Following an audit of petitioner's Article 9-A return for the 1997 short tax year, the Division of Taxation ("Division") 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.

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

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.

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

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

We make the following additional findings of fact.

> _____David O'Loughlin, an attorney for Eaton Corporation who was involved as corporate counsel in the 1997 transaction at issue here, testified that the parties intentionally structured the 1997 transaction as a stock sale for three reasons. First, by selling petitioner's stock rather than its assets, Eaton made sure it was disposing of all petitioner's liabilities. Second, purchasing stock facilitated the purchaser's financing of the transaction "because there were certain incentives for banks to lend to employee stock ownership plans." Third, petitioner had contracts with the United States Air Force. If petitioner's assets were sold, there would have been a significant administrative burden in obtaining the necessary governmental approvals. By selling stock in petitioner, rather than having petitioner sell its assets, United States government approval was not needed since petitioner remained the contracting party under the contracts with the United States Air Force (Hearing Tr., pp. 27-28). Apart from the tax treatment of the transaction, at no time did the parties to the 1997 transaction intend that the transaction be carried out as a sale of petitioner's assets (Hearing Tr., p. 28).
>
> The amount of new ITC claimed by petitioner following the 1997 transaction for the tax period from October 1, 1997 through December 31, 1997 was $1,325,427.00 and began a new seven-year potential recapture period (Pet. Exhibit "5").

[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.

> Petitioner's General Business Corporation Franchise Tax Return (Form CT-3) for the period January 1, 1997 to September 30, 1997 was entered in evidence as Division's Exhibit D. Attached to the return is Form CT-46, Claim for Investment Tax Credit, which reports recapture of investment credit of $36,609.00, apparently from routine dispositions of office equipment, and makes no reference to the transaction that is the subject of this case.
>
> Petitioner's Federal income tax return (Form 1120) for the period January 1, 1997 to September 30, 1997 was entered in evidence as Division's Exhibit G. It indicates on Schedule D and Form 4797 that as a result of the section 338 election petitioner realized a long-term capital loss with respect to goodwill of $3,793,519.00 and a section 1231 ordinary loss of $73,467,929.00.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The determination of the Administrative Law Judge observed that where New York and the Federal government have substantially similar tax provisions it has been the practice of the courts of New York to follow Federal interpretations of the statute whenever reasonable and practical. The Administrative Law Judge then reviewed the statutory history of section 338 of the Internal Revenue Code and its predecessor provisions and relevant case law. Also discussed was a statement of the Division's policy that New York State would follow the Federal policy with respect to recapture of ITC in connection with a section 338 election (***see***, TSB-M-86[3]C, April 3, 1986). The Administrative Law Judge found that petitioner's failure to recapture investment credit was inconsistent with the Federal treatment of a section 338 election which the State of New York follows and was inconsistent with petitioner's treatment of the election as a sale of assets resulting in a new tax basis.

The Administrative Law Judge next considered the Division's imposition of a penalty for substantial understatement of tax under Tax Law former § 1085(k) and whether such penalty should be waived based on a showing of reasonable cause and good faith by petitioner. Based on the Federal treatment of the present transaction and the Division's published position on the subject, it was determined that petitioner did not have reasonable cause for underreporting and did not act in good faith (***see***, 20 NYCRR 46.1[f][2]). Petitioner's reliance on ***Matter of Philip Morris*** (Tax Appeals Tribunal, November 2, 1995) was also found to be misplaced.

ARGUMENTS ON EXCEPTION

In its exception and brief, petitioner requests certain additions to the facts as found by the Administrative Law Judge. These are addressed above under Findings of Fact.

Petitioner asserts in its brief that whether there has been a "disposition" of petitioner's assets within the meaning of Tax Law § 210(12)(g)(1) is an issue of statutory interpretation and, accordingly, there is no basis for us to defer to the interpretation of the agency administering the statute. It asserts further that a disposition requires "an actual transfer" of the qualifying property and a deemed sale resulting from a section 338 election is not such an actual transfer. Moreover, considerations of Federal conformity should have less weight in petitioner's view than the intent of the New York State Legislature in enacting the investment tax credit. Petitioner's brief reviews the legislative history of the credit including statements that it was intended to stimulate new capital investment and concludes that imposing recapture in the circumstances of this case "undercuts the policy goal behind the ITC to encourage taxpayers to invest in New York property" (Petitioner's brief in support, p. 12).

Petitioner also observes that since the amount of recapture in this case is approximately \$1.8 million and the amount of new ITC claimed for the short year beginning on October 1, 1997, the day after the date of the deemed sale, is only approximately \$1.3 million, there will be a net reduction in the amount of the credit if the Division is successful. Moreover, the new ITC claimed by the deemed purchaser will be subject to a new seven-year recapture period. From these circumstances petitioner infers, "[t]he Division's position results in an obvious overall inequity to Petitioner" (Petitioner's brief in support, p. 16).

With respect to the imposition of a penalty, petitioner asserts that it reasonably relied on the absence of any mention of a deemed sale of assets in the governing regulation, 20 NYCRR 5-2.8(c), in filing its return and that this reliance is not made unreasonable by the issuance of TSB-M-86(3)C since such pronouncements do not have the force of regulations and indeed have "no legal force or effect."

The Division argued that the treatment of the transaction under the franchise tax should be governed by the Federal income tax treatment. Since the sale of stock and the section 338 election would be treated as a sale of assets resulting in recapture of the Federal investment tax credit, the same result should be found here. It notes that the enumerated exceptions to recapture in 20 NYCRR 5-2.8(e) are transactions in which the transferee's basis in the acquired assets is determined in whole or in part by reference to the transferor's basis, unlike section 338 in which the transferee takes a cost basis in the assets. The Division also argues that petitioner has not satisfied its burden of establishing reasonable cause for its underpayment that would warrant abatement of penalties. It notes that under the regulations the most important factor in determining the presence of reasonable cause is the extent of the taxpayer's efforts to ascertain the proper tax liability (***see***, 20 NYCRR 2392.1[g][2]) and asserts, "there is no evidence that petitioner made any effort at all, good faith or otherwise, to ascertain its tax liability" (Division's brief in opposition, p. 19).

OPINION

Under the Federal income tax statutes in effect for many years, a distribution of assets in complete liquidation of a corporation has been treated as an exchange in which the shareholders receive the assets of the corporation in exchange for their shares of stock. The shareholders generally realize and recognize gain or loss measured by the difference between the fair market value of the assets received and their tax basis in the shares of stock surrendered. The assets take a fair market value basis in the hands of the shareholders. For much of the history of these statutes, the liquidated corporation would have no gain or loss on such distributions.

A special rule applies to situations in which the liquidating corporation is a subsidiary of a corporate parent owning at least 80% of its stock (***see, e.g.,*** Internal Revenue Code § 332 [1986]). Those cases are treated more like corporate reorganizations in which the surviving corporation steps into the shoes of the disappearing corporation. Thus, no gain or loss is recognized to the corporations and the surviving parent corporation acquires the assets of the subsidiary with a tax basis equal to the basis of the assets in the hands of the subsidiary. The parent corporation's basis in the stock of the subsidiary simply vanishes. If the parent corporation had acquired the subsidiary's stock for the purpose of promptly liquidating it and acquiring its assets, these rules produced an untoward result in cases where the parent paid an amount for the stock that represented a substantial premium over the subsidiary's basis in its assets. To address this problem a judicial rule, generally referred to as the ***Kimbell-Diamond*** doctrine, was developed in a series of cases under which the parent corporation in those transactions would be treated as if it had purchased the subsidiary's assets for an amount equal to the amount paid for the subsidiary's stock plus the liabilities assumed in the liquidation. From the standpoint of the subsidiary, the form of the transaction would be respected and viewed as a tax-free liquidation and not a sale of assets (***see, e.g., Kimbell-Diamond Milling Co.***, 14 T.C. 74, ***affd*** 186 F2d 718, 51-1 USTC ¶ 9201, ***cert denied*** 342 US 827, 96 L Ed 626; ***Dallas Downtown Dev. Co.***, 12 T.C. 114).

In 1954, the ***Kimbell-Diamond*** doctrine was codified as section 334(b)(2) of the Internal Revenue Code of 1954. During the late 1970s and early 1980s, there was considerable scholarly and professional interest in replacing much of Subchapter C of the Internal Revenue Code, which had come to represent the historical accretion of ad hoc amendments, with formal elections based on logic and policy (***see, e.g.,*** American Law Institute, *Federal Income Tax Project: Subchapter C* [1980]); Staff of Senate Committee on Finance, 99th Cong., *Final Report on the Subchapter C Revision Act of 1985* [1985]). The more sweeping proposals which would have replaced the corporate reorganization provisions did not advance in the Congress but a "check-the-box" provision replacing section 334(b)(2) was enacted in the Tax Equity and Fiscal Responsibility Act of 1982 and is now found in section 338 of the Internal Revenue Code of 1986. Under section 338, as under section 334(b)(2), 80% of the subsidiary's stock must be acquired within a 12-month period by "purchase" as that term is defined in an elaborate provision now found in section 338(h)(3) and previously set out in section 334(b)(3). However, the requirement of a complete liquidation was replaced with an election. If made, the subsidiary would be treated as if it were a new corporation which had purchased its assets from its former self.

By making a section 338 election, the participants in the purchase and sale of a corporation can choose to have the transaction treated as a purchase and sale of assets for income tax purposes with whatever tax benefits result from that treatment while avoiding the non-tax obstacles that frequently attend an actual transfer of assets. On a sale at a loss, as in the present case, tax benefits to the seller might include converting a capital loss on the sale of stock into an ordinary section 1231 loss on the deemed sale of assets (***see***, additional findings of fact). Also, the possible application of the loss disallowance rule of Treas. Reg. § 1.1502-20 might be avoided. The testimony of Mr. O'Loughlin, Eaton's corporate counsel, catalogued the principal non-tax obstacles that would have impeded an actual asset sale in the present case (***see***, additional findings of fact). These facts bring the transaction within the basic section 338 paradigm–namely, substantial income tax advantages were achieved through the deemed-sale election and non-tax obstacles that might have impeded an actual asset transfer pursuant to a sale or a complete liquidation under section 334(b)(2) were avoided.

As a result of the enactment of section 338, every state that imposed a corporate tax based on income needed to decide if it would accept the Federal treatment of a deemed sale and, if so, with what consequences. The New York corporation franchise tax, to the extent it is based on income rather than capital, is imposed on the corporation's "entire net income." Tax Law § 208(9) provides in general that entire net income "means total net income from all sources, which shall be presumably the same as the entire taxable income . . . which the taxpayer is required to report to the United States treasury department." Thus, the starting place for the computation of income taxable under the franchise tax is the Internal Revenue Code and conformity with Federal income tax treatment is to be expected in the absence of countervailing legal or policy considerations. 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 property for purposes 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" and includes the following statement:

> Generally, 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 (emphasis added).

During the years in which petitioner acquired the property involved in this case, Tax Law § 210(12)(b) provided an investment tax credit for investments in certain qualifying property. To qualify the property had to (1) be tangible personal property or other tangible property, (2) be depreciable pursuant to section 167 of the Internal Revenue Code, (3) have a useful life of four years or more, (4) have been acquired by purchase as defined in section 179(d) of the Internal Revenue Code, (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 § 210[12][b]). Tax Law § 210(12)(g) provided for the recapture of ITC when the qualified property was disposed of or ceased to be qualifying property prior to the end of the useful life of the property. The term "disposition" is not defined in the Tax Law but the applicable regulations, 20 NYCRR 5-2.8(c), provide that a disposition of qualified property includes "a sale of the property." 20 NYCRR 5-2.8(e) lists certain transactions that do not constitute dispositions requiring recapture of ITC. The listed transactions are identified by reference to provisions of the Internal Revenue Code governing corporate reorganizations in which gain or loss is generally not recognized, tax attributes such as net operating losses are transferred to the successor corporation, and transferred assets take a tax basis equal to the basis in the hands of the transferor corporation rather than a cost basis. Not surprisingly, section 338 and its predecessor section 334(b)(2) do not appear in the list of sections.

New York's ITC was modeled after the Federal investment tax credit enacted in 1962. The legislative history of the Federal credit indicates that it was intended to stimulate capital formation and encourage the modernization and expanded use of plant and equipment (S. Rep. No. 1881, 87th Cong., 2d Sess. 153 [1962], 1962-3 C.B. 707). The Federal investment tax credit included a recapture provision similar to Tax Law § 210(12)(g). Under the Federal provision, the acquisition and liquidation of corporate subsidiaries in transactions governed by section 334(b)(2) of the Internal Revenue Code, the predecessor of section 338, were held by the Internal Revenue Service to result in recapture of the credit. Revenue Ruling 70-391, 1970-2 C.B. 2, and Revenue Ruling 73-461, 1973-2 C.B. 10, include the following statement:

> Any property distributed in the liquidation with regard to which [the liquidated subsidiary] was allowed the investment credit is, at the time of such distribution, subject to the recapture provisions of section 47 of the Code which provide for an increase in the tax of the taxpayer disposing of property before the close of the useful life that was taken into account by it in computing investment credit in prior taxable years.

The staff summary of the legislative history of section 338 consistently states that under the ***Kimbell-Diamond*** doctrine and section 334(b)(2) "[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" (Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*).

Petitioner notes that although TSB-M-86(3)C did reflect the Division's policy on ITC recapture, the Division has not amended 20 NYCRR 5-2.8 to reflect that policy. 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. 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). TSB-M-86(3)C does not have any legally binding effect but it states a straightforward interpretation of the governing statute. The Division is not required to promulgate regulations simply to acquiesce in the treatment prescribed by the Internal Revenue Code since the Tax Law makes the Federal income tax determination of income the starting place for the calculation of the franchise tax on "entire net income."

It could be argued that Tax Law § 208(9) merely makes Federal taxable income the presumed equivalent of entire net income and has no bearing on the recapture of a tax credit because that calculation occurs "below the line" of "income." We think that section 208 should not be read so narrowly. Consistent with the statutory theme of beginning with Federal income tax calculations, the courts of New York have generally followed the Federal construction of similar provisions found in the Tax Law (***see***, ***Matter of Marx v. Bragalini***, 6 NY2d 322, 189 NYS2d 846; ***Matter of Hunt v. State Tax Commn.***, 65 NY2d 13, 489 NYS2d 451 [personal income tax]; ***Matter of Dreyfus Special Income Fund v. New York State Tax Commn.***, 126 AD2d 368, 514 NYS2d 130, ***affd*** 72 NY2d 874, 532 NYS2d 356 [corporation franchise tax]; ***Matter of Behm***,19 AD2d 234, 241 NYS2d 264, ***affd*** 14 NY2d 826, 251 NYS2d 475 [estate tax]). 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. v. Tax Appeals Tribunal***, 185 AD2d 466, 585 NYS2d 867, ***lv denied*** 80 NY2d 761, 592 NYS2d 670; ***Matter of Reynolds***, Tax Appeals Tribunal, March 9, 1995). Based on the foregoing, we conclude that the Division acted well within its authority in requiring the recapture of ITC as a result of the section 338 election.

The Division assessed a penalty against petitioner for substantial understatement of tax pursuant to Tax Law former § 1085(k). Even if there is a substantial understatement of tax, former section 1085(k) provides that the "amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return." The penalty may also be waived on a showing that the there was "reasonable cause for the understatement" and that the taxpayer "acted in good faith."

Line 1 of the New York Business Corporation Franchise Tax Return (Form CT-3) filed by petitioner for the short year ended September 30, 1997 is captioned "Federal taxable income before net operating loss and special deductions" (***see***, Division's Exhibit "D"). The entry on that line of petitioner's return, a loss of $61,520,326.00, is taken from line 30, "Taxable Income," on petitioner's U.S. Corporation Income Tax Return (Form 1120) for the same period and reflects the Federal loss recognized on the deemed sale of petitioner's assets pursuant to section 338 (***see***, Division's Exhibit "G"). Thus, the computation of entire net income for purposes of the franchise tax automatically reflects the Federal deemed-sale treatment prescribed by section 338. When petitioner arrived at the place on the New York return where recapture of ITC on the deemed sale would have been reflected, Form CT-46, Schedule E (1997), conformity with the Federal treatment ceased without explanation (***see***, additional findings of fact). There is no statement on the return or statement attached to the return that would represent the kind of disclosure contemplated by former section 1085(k) in order to reduce the penalty. Petitioner has also cited no case, ruling or other document that would represent "substantial authority" for the treatment it adopted on its return. Indeed, petitioner has cited no authority of any kind in which deemed-sale treatment prescribed by section 338 was disregarded for any purpose in calculating the Federal income tax or New York corporation franchise tax or New York City general corporation tax of a target corporation that is deemed to have sold its assets and liquidated (***cf***. Petitioner's brief in support, pp. 12-15). Pronouncements of tax collectors and courts of other states applying other laws and policies and authorities involving excise taxes and other taxes not based on income clearly have no relevance.

Petitioner maintains that 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, which identified specific examples of dispositions, but do not include a stock sale (***see***, Petitioner's exception, p. 6). The regulations, however, do identify as a disposition "a sale of the property" which is precisely the characterization of the transaction that petitioner chose by making an election under section 338 (***see***, 20 NYCRR 5-2.8[c]). This is not a question of form and substance as petitioner contends in its briefs (***see***, Petitioners's brief in support, p. 3; Petitioner's reply brief, p. 2). The election provided to taxpayers by section 338 gives them the option of treating a transaction as something that it is not in either form or substance. Having made the choice of treating the transaction as a sale of assets in order to obtain significant tax benefits, petitioner should have accepted the tax detriments that flow from that choice.

The hallmarks of reasonable cause and good faith, such as "efforts to ascertain the proper tax liability," "an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer," and "reliance by the taxpayer on any written information [or] professional advice" are demonstrably absent from the record in this case (***see***, 20 NYCRR former 46.1[f][2]; 20 NYCRR 2392.1[g]). Although a member of Eaton Corporation's tax staff testified at the hearing, no testimony or other evidence was presented concerning the circumstances surrounding the preparation of the tax returns or other facts that might support a finding of reasonable cause and good faith (Hearing Tr., pp. 118-122).

The fine hand of expert tax planners seems evident in this transaction. For example, the choreographed steps of transferring the seller's stock in petitioner to the buying corporation in exchange for stock and then selling the buyer's stock to new investors seems carefully designed to avoid the possible application of section 318 and section 351 which would have disqualified the transaction as a "purchase" under section 338(h)(3) (***see, e.g., Bijou Park Props.***, 47 T.C. 207). In this setting, it beggars credulity to suggest that the failure to report recapture was simply the innocent oversight of an insouciant accountant.

A factor that makes this case particularly egregious is the "double dipping" or "whipsaw" involved where the buyer and seller in the transaction are in effect claiming the same tax benefit to the detriment of the tax collector. In light of the published position of the Division, the seller knew or should have known that the purchaser would claim ITC on its new cost basis in the qualifying property and that this was inconsistent with the seller's failure to report recapture. If petitioner honestly believed that recapture was inappropriate, it might have obtained a resolution of the issue by paying the tax and then claiming a refund or by making the kind of special disclosure on its return that is expressly contemplated by Tax Law former § 1085(k). It did neither. It is hard to escape the suspicion that petitioner hoped that the matter would slip through the audit net unnoticed. This is behavior for which the predictable sting of the substantial understatement penalty is an appropriate deterrent.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of AIL Systems, Inc. is denied;

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

3. The petition of AIL Systems, Inc. is denied; and

4. The Notice of Deficiency dated October 21, 2002 is sustained.

DATED: Troy, New York
May 4, 2006

/s/Charles H. Nesbitt
Charles H. Nesbitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Robert J. McDermott
Robert J. McDermott
Commissioner