

STATE TAX COMMISSION

REVISÉ
DECISION

Whether the Tax Benefit Rule, as provided under section 58(h) of the Internal Revenue Code, is applicable for New York State and City purposes.

FINDINGS OF FACT

1. On September 21, 1981, Malcom P. McLean and his wife, Margaret S. McLean, late filed a joint New York State Income Tax Resident Return (with City of New York Personal Income Tax) for the year 1980. On such return, petitioners showed no New York State or City personal income tax liability, based primarily on a claimed net operating loss carryforward of \$11,961,766.16. However, New York State and City minimum income taxes were computed and paid on the following reported items of tax preference:

	<u>Amount</u>
Accelerated depreciation on real property	\$ 590,625.00
Capital gain deduction	<u>\$13,544,930.00</u>
Total federal items of tax preference	\$14,135,555.00
New York addition - section 622(a)(3)	
restoration of net operating loss deduction	<u>\$ 3,265,241.00</u>
Balance	\$17,400,796.00
Less: 20% capital gain deduction	<u>\$ 2,708,986.00</u>
Total New York items of tax preference	<u>\$14,691,810.00</u>

2. On their return, petitioners claimed a basis adjustment of \$2,025,000.00 with respect to stock sold in 1980.

3. On November 7, 1983, the Audit Division issued a Statement of Audit Changes to petitioners wherein their New York State and City minimum income taxes were recomputed based on the following explanation:

"In regards to the basis adjustment of \$2,025,000.00 deducted from your Federal capital gain in arriving at your New York capital gain please be advised of the following:

The subtraction modification permitted under Section 612(c)(4) applies to the disposition of property where the rules for computation of the basis under Article 16 are different from the federal rules. If the computation of the basis under Article 16 results in a higher basis than the basis for Federal income tax purposes and the property was owned by the taxpayer at the end of the last year taxable under Article 16 is not determined as being the fair market value as of December 31, 1959. The basis determined as starting with the date of acquisition of the property. [sic]

There is **no** deduction that basis computed under Article 16 of stock sold in 1980 would be any different than the basis for federal income tax purposes." [sic]

4. Based **on** the above statement, a Notice of Deficiency was issued against petitioners **on** January 5, 1984, asserting additional New York State and City minimum income taxes of \$216,896.14, plus interest of \$70,845.07, for a total due of \$287,741.21.

5. On April 3, 1984, petitioners filed a petition wherein, in addition to contesting the disallowance of the section 612(c)(4) modification, they further claimed that:

"**In** arriving at petitioners' 1980 minimum taxable income \$3,265,241 was included as the New York State Addition for Restoration of Net Operating Loss Deductions (Section 622(a)(3) of Article 22). However, the full net operating **loss** carryover reflected **in** the 1980 return was not utilized to reduce 1980 taxable income. Therefore to the extent the net operating **loss** was not 'restored' it should not increase 1980 minimum taxable income."

Relief sought, according to said petition, was as follows:

"a. Redetenaination and full abatement of the \$216,896.14 deficiency...

b. Refund in the amount of \$118,829..."

6. At the hearing, petitioners filed an Amended Petition. Redetermination was claimed therein **on** the amended ground that:

"-- to the extent the net operating loss carryover was not utilized (a) the net operating deduction **for** minimum tax purposes was not 'restored' and (b) 1980 minimum taxable income should not include items **of** tax preference to the extent that **no** tax benefit was derived in 1980 by petitioners for such items of tax preference."

Relief sought, according to the Amended Petition, was as follows:

"a. Redetermination and full abatement of the \$316,896.14 deficiency...

b. Refund in the amount of \$272,178..."

7. During the hearing, petitioners conceded the issue with respect to the basis adjustment. However, petitioners maintained that they are properly due a refund because the New York return as filed incorrectly included in minimum taxable income \$3,265,241.00 of prior years' tax preference items for which no tax benefit was derived and such return also failed to exclude \$1,516,569.00 of 1980 tax preference items which did not reduce the petitioners' 1980 taxable income. Petitioners argued that application of the "tax benefit rule" results in their being entitled to a net refund in the amount of \$189,558.00 rather than being liable for the deficiency of \$216,896.14."

8. Petitioners' 1980 federal taxable income before application of the \$11,961,766.00 net operating loss from prior years was \$7,179,956.00; therefore, \$4,781,810.00 of the net operating loss carried to 1980 was not used to reduce 1980 federal taxable income. By operation of Internal Revenue Code section 172(d)(2)(B), the \$4,781,810.00 unused net operating loss could not be carried forward to any subsequent year. Said section required the long-term capital gain deduction for 1980 of \$17,468,919.00 to be added back to 1980 income to determine whether any of the net operating loss for years prior to 1980 could be carried forward from 1980 to subsequent years. Adding back the \$17,468,919.00 capital gain deduction to 1980 income more than offset the \$4,781,810.00 net operating loss remaining to be carried over.

9. In their 1980 New York income tax return as originally filed, petitioner: claim that they erroneously "restored" the tax preference items of prior years in the amount of \$3,265,241.00. In the Amended Petition, petitioners omitted this restoration and, in addition, reduced 1980 tax preference items by the difference between \$3,265,241.00 and \$4,781,810.00, or \$1,516,569.00, the

extent to which 1980 tax preference items did not serve to reduce 1980 taxable income.

10. Petitioners contend that section 58(h) of the Internal Revenue Code (the tax benefit rule) is properly applicable to New York State and City minimum income tax. Accordingly, they argued that they are properly due a refund of \$189,558.00, computed as follows:

COMPUTATION OF REFUND

Recalculation of Minimum Tax:

1980 Tax Preference Items:

1. Capital gain deduction

Federal Capital Gain

\$29,114.866

Capital Gain deduction at 60%

\$17,468,919

2. Accelerated depreciation

590,625

Total 1980 Tax Preference Items

18,059,544

Less - Amount of 1980 Tax Preference items for which federal taxable income was not reduced and no tax benefit derived -

Total unused net operating loss carryover to 1980

\$4,781,810

Less - prior year net operating loss deductions included in the unused net operating loss carryover to 1980

\$3,265,241

1980 Tax Preference items for which no tax benefit was derived

1,516,569

1980 Tax Preference items for which tax benefit was derived

16,542,975

Less - 20% of capital gain deduction

3,493,783

13,049,192

Less specific deduction

5,000

Minimum Taxable Income

13,044,192

Minimum Tax at 8.5%

1,108,756

Tax Paid

1,298,314

Refund

\$ 189,553

II The Audit Division's position is that petitioners properly computed the net operating **loss** restoration on their original return in accordance with section 622(a)(3) of the Tax Law and that since Internal Revenue Code section 58(h) does not change the meaning of items **of** tax preference, said section is not applicable for New York State and City purposes.

12. During the hearing, the Audit Division submitted a notice **of** additional deficiency wherein an additional deficiency of \$5,112.16 **was** asserted as follows:

"Audit failed to recognize 'adjusted itemized deductions' as an item of tax preference **as** follows:

Itemized Deductions	\$68,804.50
Less Medical Deductions	<u>8,543.80</u>
	\$60,260.70
Less 60% AGI	<u>-0-</u>
Adjusted Itemized Deduction	\$60,260.70
New York State Minimum Tax	3,615.64
New York City Minimum Tax	<u>1,506.52</u>
Total Tax	\$ 5,112.16" ¹

13. Petitioners did not challenge the addition to items **of** tax preference **of** adjusted itemized deductions.

CONCLUSIONS OF LAW

A. That the Audit Division's adjustment disallowing petitioners' claimed adjustment to the basis **of** stock sold during 1980 is sustained since petitioners have conceded said adjustment by the Audit Division (see Findings of Fact "2", "**3**" and "**7**" supra).

B. That section 622 of the Tax Law provides, in pertinent part, that:

¹ The Audit Division erroneously calculated the total tax as \$5,112.16.

"(a) The New York minimum taxable income...shall be the **sum** of the items of tax preference...reduced (but not below zero) by the aggregate of the following:

* * *

(3) ...the amount of any net operating **loss** of the taxpayer, as determined for federal income tax purposes, which remains **as** a net operating **loss** carryover to a succeeding taxable year. **In** such case, however, the amount of such net operating loss used to reduce the sum of the items of tax preference shall be treated as an item of tax preference **in** the next succeeding taxable years, in order **of** time, in which such net operating **loss** carryover reduced federal taxable income."

C. That Internal Revenue Code section 58(h) and the regulations promulgated thereunder govern a taxpayer's treatment under the tax benefit rule. Section 58(h) was enacted to eliminate the inequities that resulted for taxpayers who were required to pay a minimum tax **on** items for which they did not receive a tax benefit.

D. That recently, the New York State Court **of** Appeals has interpreted the language found within sections 622 and 607 of the Tax Law (and consequently, sections T46-122.0 and T46-107.0 **of** the Administrative Code of the City of New York) to provide for the application of section 58(h) of the Internal Revenue Code to the New York State (and City) laws except in those instances when section 622(b) (and section T46-122.0[b]) specifically modify the federal rules (see Matter of Hunt v. State Tax Commn., 65 NY2d 13).

E. That although section 622(a)(3) of the Tax Law provides for the "restoration" of \$3,265,241.00 of prior year tax preference items, petitioners received **no** tax benefit from such prior year tax preference items. Accordingly, section 58(h) of the Internal Revenue Code is applicable and the aforestated amount should not be added to petitioners' 1980 items of tax preference.

F. That, additionally, petitioners may properly exclude \$1,516,569.00 of

G. That section 689(e) of the Tax Law and section T46-189.0(e) of the Administrative Code of the City of New York provide that:

"In any case before the tax commission...the burden of proof shall be upon the petitioner except for the following issues, as to which the burden of proof shall be upon the tax commission:

* * *

(3) whether the petitioner is liable for any increase in a deficiency where such increase is asserted initially after a notice of deficiency was mailed and a petition under this section filed...".

H. That the adjusted itemized deductions of \$60,260.70 are properly includible as an item of tax preference during the year at issue. Since said amount was computed from amounts reported by petitioners on their return, the Audit Division has sustained its burden of proof.

I. That petitioners are properly due a refund of New York State and City minimum income tax of \$184,435.00 computed as follows:

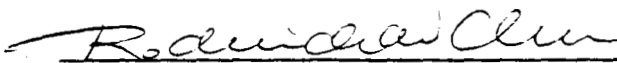
Minimum Taxable Income as	
computed by petitioners (see	
Finding of Fact "10", <u>supra</u>)	\$13,944,192.00
Add: Adjusted Itemized Deductions	60,260.70
Corrected Minimum Taxable Income	<u>\$13,104,452.70</u>
Minimum Tax at 8.5%	\$ 1,113,879.00
Tax Paid	<u>1,298,314.00</u>
Refund Due	<u><u>\$ 184,435.00</u></u>

J. That the petition of Malcom P. McLean and Margaret S. McLean is granted to the extent provided in Conclusions of Law "E", "F" and "I" that the Notice of Deficiency issued January 5, 1984 is cancelled and the Audit Division is directed to refund the sum of \$184,435.00, together with such interest as may be lawfully owing.

DATED: Albany, New York

STATE TAX COMMISSION

FEB 13 1987


PRESIDENT
