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Logic vs. the Statute: When Federal Conformity Makes No Sense Peter L. Faber

Summary by taxanalysts®

Peter L. Faber of **McDermott Will & Emery** writes about how taxpayers have a chance to decouple from federal taxable income in court if they can demonstrate that the basis for some federal tax provisions do not apply to the state because of differences between the federal and state tax regimes.

Full Text Published by taxanalysts®

Peter L. Faber is a partner with **McDermott Will & Emery** in New York.

In this article, Faber writes about how taxpayers have a chance to decouple from federal taxable income if they can demonstrate that the basis in the statute for some federal tax provisions doesn't apply to the state because of differences in the federal and state tax regimes.

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State income tax statutes generally define taxable income by starting with federal taxable income and adjusting it up or down to reflect areas in which state and federal tax policies diverge. Unfortunately, there are situations resulting in a federal tax consequence that should not result in a parallel state tax consequence because of differences between the federal and state tax regimes. As a result, taxpayers often find themselves in situations in which literal conformity to federal taxable income makes no sense. State legislatures, through inadvertence or inattention, have sometimes failed to increase or decrease federal taxable income when they should have. In those cases, literal conformity to federal taxable income is required by the statute, yet it flies in the face of logic and common sense. Often, the courts have intervened, disregarding the statutory language to bring about a sensible result.

Taxpayers should be aware that they can successfully argue for decoupling from federal basis in calculating gain or loss when assets are sold. We see this issue often in the context of corporate acquisitions. If a parent corporation and its subsidiary file consolidated federal income tax returns, the parent's basis in the subsidiary's stock is adjusted every year to reflect different aspects of their relationship. Treasury regulations provide, for example, that the parent's basis is increased by the subsidiary's net income. In effect, the subsidiary's income is treated as if it had been distributed to the parent and then dropped down to the subsidiary as a contribution to capital. That is consistent with how the income is treated on

the consolidated return. Conversely, the parent's basis in the subsidiary's stock is reduced by the subsidiary's losses that are used on the consolidated return.¹ If the parent and its subsidiary are filing separate income tax returns in one or more states, the predicate for the basis adjustment is absent. In those states, the corporations are treated as separate taxpayers and there is no reason to adjust the parent's basis in the subsidiary's stock to reflect the subsidiary's operations or transactions between the corporations, yet literal compliance with the conformity statute would require that the federal basis adjustments be made for state tax purposes.

Another instance in which federal basis adjustments should not apply at the state level involves federal credits that require a basis reduction in the amount of the credit. An example is the investment credit provided by IRC section 48. IRC section 50 requires the taxpayer to reduce the basis of the relevant property to reflect the credit granted by section 48. States typically do not adopt federal credits, so the predicate for the federal basis adjustments is not present at the state level. Nevertheless, literal adherence to state taxing statutes would require application of the federal basis adjustments.

A recent administrative law judge decision in New York illustrates how taxpayers may be able to obtain the equivalent of equitable relief when literal adherence to a statute requiring conformity to the federal definition of taxable income is at odds with logic. *TD Holdings II Inc.*² involved the calculation of a corporation's net operating loss carryovers. The taxpayer was a bank subject to New York state's franchise tax on banking corporations.³ The taxpayer incurred an NOL of \$9,259,151 during its 2005 tax year for New York tax purposes. The taxpayer and its affiliates filed a pro forma return reflecting the income and deductions that they would have reported had they filed their own consolidated federal income tax return (they were part of a larger federal consolidated return group). Under that scenario, \$3,767,459 of the 2005 federal NOL would have been used in the 2006 tax year, in which the corporations had net income for federal tax purposes, and the remaining \$7,979,587 would have been carried forward from its 2006 tax year. However, no part of the NOL was in fact used for New York tax purposes because for that year its income was sufficiently low that it paid New York tax not on net income but rather on the amount of its capital. Under New York law, a bank paid tax equal to a percentage of its capital if that would produce a higher tax than a tax based on a percentage of its taxable income. TD Holdings therefore argued that the 2005 NOL produced no New York state tax benefit in 2006 and hence it should not be reduced by the amount of the NOL that was used, and that produced a tax benefit, for federal income tax purposes.

The ALJ held, as requested by the taxpayer, that the 2005 NOL produced no New York state tax benefit in 2006 and hence did not have to be reduced by the amount of the federal NOL that was applied against federal income during that year.⁴

The ALJ pointed out that New York's conformity statute contains an out for those seeking to depart from the literal application of federal taxable income. It provides that New York state taxable income "presumably" will be the same as federal taxable income. Although the New York courts have generally held that the word "presumably" does not authorize departures from federal taxable income, the ALJ believed this language provided some flexibility.⁵

The ALJ pointed out that the purpose of the NOL carryforward rules was to allow a taxpayer to offset the income of its profitable years by losses of its unprofitable years so that over time its liability would be based on its multiyear income. The NOL statute stated that the New York NOL could not exceed the federal NOL, but it did not say that it could not be less than the federal NOL. Moreover, the provision in the statute that the New York NOL deduction was "presumably" the same as its federal NOL deduction for the same year suggested that it did not have to be the same as the federal NOL.⁶ The company's taxable income for 2006, computed without regard to the NOL, was sufficiently low that its tax for that year would have been computed on the capital base without regard to the NOL. If its taxable income had been sufficiently high that its tax for that year would have been based on taxable income had the NOL not existed, a New York benefit would have been produced to the extent that the NOL reduced taxable income to the point at which capital becomes the basis for computing the tax. The NOL would have then produced a New York state tax benefit, and presumably the NOL carryover to future years would have been reduced by that amount.

The ALJ in *TD Holdings* cited with approval the New York State Tax Appeals Tribunal's decision in *Brooke-Bond Group (U.S.) Inc.*⁷ That case involved similar facts to those in *TD Holdings*, and the tribunal held that the taxpayer was not required to reduce its New York state NOL by federal NOLs that produced a federal tax benefit but no New York state tax benefit. The tribunal said that "to require that petitioner lose the ability to carry forward or backward a portion of its New York state NOL simply to achieve conformity with the amount of the federal deduction seems at odds with the fundamental purpose for which Tax Law section 208(9)(f) was enacted." It said that the amount of the federal NOL might be the "starting point" for the calculation of the New York state NOL, but it did not have to be the ending point.

Courts in Other States Have Addressed the Basis Adjustment Question

Several cases in New Jersey hold that federal basis adjustments do not have to be made for New Jersey purposes in situations in which the New Jersey and federal tax schemes are different.

In *Koch v. Director, Division of Taxation*,⁸ the New Jersey Supreme Court held that adjustments to the basis of a partner's interest in a partnership did not have to be made for New Jersey purposes. The taxpayer, an individual, had sold a partnership interest in a limited partnership. The partnership had sustained losses that under federal income tax rules required him to reduce the basis of his partnership interest by the amount of the losses he had deducted on his federal income tax returns. The losses were not deductible for New Jersey tax purposes and, accordingly, the taxpayer took the position that he did not have to reduce the basis in his partnership interest for New Jersey income tax purposes by losses that produced no New Jersey tax benefit. The court agreed. The court said that although the statute literally required federal adjusted basis be used in calculating gain on the sale of property, this was done "for administrative convenience and simplicity" and that it should not be controlling in all cases. The court said that "a statute is to be interpreted in an integrated way without undue emphasis on any particular word or phrase and, if possible, in

a manner which harmonizes all of its parts so as to do justice to its overall meaning," and that it must be "read in full light of its history, purpose and context." In fact, the court said, Koch's calculation of gain was consistent with the statutory mandate to follow federal accounting principles. Under federal law, basis would be reduced only by losses that produced a federal tax benefit and the same principle should apply in New Jersey.

In *Walsh v. State of New Jersey, Department of the Treasury, Division of Taxation*,⁹ the New Jersey Tax Court held that shareholders of an S corporation did not have to reduce the basis of their stock in the corporation by the amount of S corporation losses they had deducted on their federal individual income tax returns, as was required for federal income tax purposes. At the time, New Jersey did not recognize subchapter S of the IRC and treated S corporations as regular C corporations. Accordingly, shareholders of federal S corporations could not deduct their shares of the corporation's losses on their New Jersey individual income tax returns. The tax court said that, although the New Jersey statute required literal conformity with the federal rules in calculating gain, under the tax department's view "S corporation losses would reduce the shareholder's basis by the amount of the corporation loss and increase his taxable gain, even though the shareholder received no benefit from the loss. As taxpayers point out, the result is a tax on the return of capital, a result that could not have been intended by the New Jersey Legislature." The court also pointed out that under federal tax accounting principles, stock basis was to be reduced only by losses producing a tax benefit and that applying those principles in the New Jersey context resulted in no basis reduction.

Two New Jersey cases involved basis adjustments resulting from depreciation deductions. In *Moroney v. Division of Taxation*,¹⁰ individual taxpayers sold rental real estate. In each year in which they held the property, their operating expenses exceeded rental income. As a result, their depreciation deductions produced no tax benefit for them. The court held that they did not have to reduce their bases in the property by the unused depreciation deductions. The court relied on *Koch* and *Walsh* in finding for the taxpayers. It held that the depreciation deductions produced no New Jersey tax benefit for them, so therefore their cost basis in the property should not be reduced by the unused deductions. It said that the critical element in *Koch* and *Walsh* was not that the losses were not properly deductible but, rather, that they produced no tax benefit that could justify reducing the taxpayer's basis. Last year the New Jersey Tax Court reaffirmed that principle in *Toyota Motor Credit Corp. v. Division of Taxation*.¹¹ The taxpayer conducted a vehicle leasing business. After leasing vehicles, it typically sold them. As is common in rental operations, the taxpayer sustained losses, and, as a result, the depreciation deductions that it could have claimed would have produced no tax benefit. Because of limitations in the New Jersey statute, the taxpayer could not have used the resulting NOLs. New Jersey having decoupled from federal bonus depreciation was a further indication that the federal bases should not apply for New Jersey tax purposes. The court said that "the Legislature intended to tax only an entity's actual economic gains -- the accessions to its wealth -- from the sale of its property and not artificial gains resulting from unused depreciation deductions."

Similar Issues Have Arisen in Other Contexts

*T.H.E. Investment Corp. v. Massachusetts Commissioner of Revenue*¹² involved the

recapture of excess loss accounts under the federal consolidated return regulations. Under those regulations, a parent corporation's basis in the stock of its subsidiary corporation is reduced by the subsidiary's losses. If those negative adjustments exceed the parent's basis in the subsidiary's stock, the net deficit becomes an excess loss account.¹³ If the parent later disposes of its subsidiary's stock, the amount of the excess loss account is in the parent's income for the year of the disposition. If the subsidiary is insolvent at the time of the disposition, the recaptured excess loss account is treated as ordinary income. A disposition is considered to have occurred on the last day of the subsidiary's tax year in which any of its stock becomes worthless.¹⁴ In that case, the parent and its subsidiary filed separate income tax returns in Massachusetts, so the subsidiary's losses that created the federal excess loss account never reduced the parent's taxable income in Massachusetts. The Appellate Tax Board viewed the recapture provisions of the federal consolidated return regulations as being intended to recover previous tax benefits that, because of a disposition, were effectively restored to the parent's net worth. The board said that the definition of gross income under the Massachusetts statutes was not "intended to include amounts which do not represent real increases in wealth to the taxpayer in the tax year merely because the federal government has chosen to make adjustments for federal tax reasons that do not represent income subject to tax in Massachusetts. The legislative intent is to be ascertained from the statute as a whole, lending every section, clause, and word such force and effect as are reasonably practical to the end that as far as possible, the statute will constitute a consistent and harmonious whole, capable of producing a rational result consonant with common sense and sound judgment." In effect, the board held that there should be a departure from federal taxable income when differences between the Massachusetts treatment of the taxpayer and the federal treatment were such that the rationale for including an item in income for federal tax purposes did not apply for Massachusetts tax purposes.

*The Bank of Baltimore v. State Department of Assessments and Taxation*¹⁵ involved the recapture of a bad debt reserve. The taxpayer, a bank, had used the reserve method for calculating its deduction for bad debts for federal income tax purposes. The IRC was amended in 1987 to provide that banks could no longer use the reserve method for calculating their bad debt deductions. Under the new regime, they could only deduct specific debts when they became uncollectible. Taxpayers that had previously used the reserve method for deducting bad debts were required to recapture any existing reserves on their federal income tax returns, although they were allowed to spread the resulting income over five years. The recapture of the taxpayer's bad debt reserve increased its federal taxable income for those years. Maryland law did not allow banks to use the reserve method for deducting bad debts during the years in which the taxpayer was using the reserve method for federal income tax purposes. The taxpayer reduced its federal taxable income for the years during which the reserve was recaptured for federal income tax purposes by the amount of the recapture income, and the Maryland Department of Assessments and Taxation initially accepted that treatment. In later years, the bank incurred NOLs for federal income tax purposes and filed amended returns, reducing its income for prior years. It claimed a refund for the years over which the federal recapture income was spread. The department denied the refund, taking the position that the taxpayer had to include its federal recapture income in its income for those years, thereby reducing the effect of the NOL carryback. The Maryland Tax Court rejected the department's position. It said that "strict adherence to the reporting requirements as found on the franchise tax form results in a tax windfall or unjust enrichment to the State contrary to the federal conformity

doctrine. The result is a double tax on the amount included in federal taxable income as recapture, which was added to federal taxable income in prior years for computation of the franchise tax." Because the taxpayer had not used the reserve method for deducting bad debts for Maryland tax purposes, it had received no Maryland tax benefit from the additions to the federal bad debt reserve; therefore, it was inappropriate for the department to require the recapture of income that had never been deducted.

In *Weston Marketing Corp. v. Commissioner of Revenue*,¹⁶ the Massachusetts Appellate Tax Board held that a taxpayer that recaptured losses previously taken regarding futures contracts under the federal mark-to-market regime for federal income tax purposes when it later sold those contracts was not required to include the recapture income in its Massachusetts income when the losses had not been deducted for Massachusetts purposes. The board held that they could be subtracted from federal taxable income in computing Massachusetts taxable income, even though under the Massachusetts statute Massachusetts income was based on federal taxable income and there was no explicit adjustment for the recapture income.

*Appeal of Rapid-American Corp.*¹⁷ involved a departure from federal taxable income sought by the government. The taxpayer filed consolidated federal income tax returns and combined California income tax returns with some subsidiaries. It sold the stock of some of its subsidiaries, and, in calculating its gain, it increased its basis in the stock of the sold subsidiaries by the amount of the earnings and profits that had been reported on its consolidated federal returns, as permitted by the federal consolidated return regulations.¹⁸ California had not adopted a similar regulation. The subsidiary was not required to file a California return and did not pay California tax, but the State Board of Equalization noted that it "may potentially have had a portion of its earnings and profits in the California tax returns filed by the parent (by reason of said earnings and profits being contained in a combined report filed by a unitary group of which the subsidiary and the parent were members)." The BOE rejected the taxpayer's contention that failing to adjust the basis would result in the same earnings being taxed twice.

Some authorities have gone the other way, however, and have rejected attempts to depart from federal taxable income despite arguments that to do so would be illogical.

In a Maryland case, the court of appeals held that a taxpayer had to follow the federal tax treatment of the distribution of an item of property when departing from the federal tax treatment would result in incongruous results for Maryland tax purposes. *NIHC Inc. v. Comptroller of the Treasury*¹⁹ involved a subsidiary corporation that tried to include income on the distribution of property to its parent that would have had the result of saving Maryland taxes. The income was in the subsidiary's income for federal income tax purposes, but the court rejected the taxpayer's attempt to include it for Maryland purposes. National retailer Nordstrom Inc. owned valuable trademarks. To save state taxes, Nordstrom formed three subsidiaries, NTN, NIHC, and N2HC. Nordstrom transferred its trademarks to NTN, and in return NTN gave Nordstrom a license to continue to use the trademarks. Nordstrom then transferred its stock in NTN and NIHC to N2HC for cash, so N2HC became NIHC's sole shareholder. The license between NTN and Nordstrom was then terminated, and NTN entered into a new license with NIHC that gave NIHC the right to use and sublicense the Nordstrom trademarks. On the same day, NIHC distributed the

license agreement with NTN to its parent, and N2HC then granted Nordstrom a license to use the trademarks.

Under federal income tax law, the distribution of the license agreement from NIHC to N2HC was a distribution of appreciated property that technically resulted in recognized gain under section 311(b) of the IRC. Under the federal consolidated return regulations, that gain was deferred over 15 years.²⁰ That corresponded to the period over which trademarks were normally amortized for federal income tax purposes. However, NIHC and N2HC filed separate Maryland income tax returns that showed no income apportionable to Maryland from those transactions. The taxpayer argued that the gain should not be deferred for Maryland income tax purposes because the corporations filed separate Maryland income tax returns, and therefore the premise for deferring the section 311(b) gain was not present. The taxpayer sought to have the entire gain in its Maryland income in the year of the distribution, which served its purposes because the statute of limitations for assessing tax deficiencies for that year had expired. The court rejected that argument for what appeared to be equitable reasons. It apparently felt that the taxpayer was attempting to gain an inappropriate tax benefit through the statute of limitations, and it required the taxpayer to follow the federal tax treatment even though that treatment was based on the filing of consolidated tax returns and the companies had filed separate Maryland returns.

In *Erdle v. Dorgan*,²¹ shareholders of a federal S corporation were allowed to increase the basis of their stock by their shares of the corporation's undistributed earnings, as permitted by federal tax law. The corporation had elected to be treated as a regular C corporation for North Dakota purposes, and the commissioner of taxation held that, because the undistributed corporate earnings were not taxed to the shareholders in North Dakota, they should not be used to increase the basis of the shareholders' stock. According to the court:

The ultimate question to be resolved regarding that issue is whether or not our statutes provide for an adjustment to federal taxable income to reflect differential treatment of a taxpayer's stock basis in a corporation which elects Subchapter S treatment for federal tax purposes and regular tax treatment for state tax purposes. On reviewing our tax statutes, we have found no such provision, nor has the commissioner directed us to any statutory language which would allow such an adjustment.

That the predicate under the federal tax system for adjusting the stock basis was not present in North Dakota was of no importance. The court held that the statutes literally read required conformity to the federal tax basis.

In *State Department of Revenue v. Robertson*,²² the Alabama Court of Civil Appeals required a taxpayer to reduce the basis of real property by depreciation deducted on his federal income tax returns during years in which he did not live in Alabama and did not file Alabama tax returns. The court noted that the Alabama statutes required the tax basis of property to be reduced by depreciation deductions and that there was no exception for depreciation that did not result in an Alabama tax benefit. The court pointed out that federal courts have required basis to be reduced by depreciation deductions for years during which the taxpayer was not a U.S. citizen and derived no federal tax benefit from the deductions.²³

The court did not regard gain resulting from depreciation-caused basis adjustments as the equivalent of the recapture of a tax benefit.

The Massachusetts Appellate Tax Board required literal conformity to the federal rules in *R.J. Reynolds Tobacco v. Commissioner*.²⁴ A subsidiary corporation distributed appreciated property to its parent. The corporations filed consolidated federal income tax returns but separate Massachusetts income tax returns. The subsidiary's gain on the distribution of the property, which otherwise would have been taxed immediately under IRC section 311(b), was recognized but deferred under the federal consolidated return regulations.²⁵ The DOR argued that the rationale for deferral was not present because the corporations had filed separate Massachusetts returns. The board rejected that contention, however, saying that there was "no authority for the proposition that the Commissioner can engraft the 'rationale' of the federal legislation onto Massachusetts tax provisions."

In *Berkley v. Commissioner of Revenue*,²⁶ the Connecticut Superior Court held that shareholders of an S corporation must reduce the basis in their S corporation stock by their shares of the corporation's losses that were deducted for federal income tax purposes, even though the losses resulted in no Connecticut tax benefit because Connecticut did not have an income tax during the years at issue. The court rejected the taxpayers' argument that they derived no Connecticut tax benefit from the losses, pointing out that, although they did not derive a Connecticut tax benefit, they did receive a federal tax benefit. The court viewed the tax benefit rule as being an equitable concept and said that under all the circumstances it was not inequitable to require the taxpayers to use the federal basis in their stock in calculating their gain.

The law in that area, as in so many others, is unsettled, but it is clear that taxpayers seeking to depart from federal taxable income notwithstanding statutory language requiring conformity to federal taxable income have a reasonable chance of success in court if they can show that the predicates for some federal tax provisions do not apply in the relevant state because of differences between the federal and state tax regimes. It is a well-accepted principle of statutory construction that a statute's literal language will not be followed when to do so would produce an absurd result.²⁷ That principle should be applied to tax statutes as well as to other statutes.

FOOTNOTES

¹ Treas. reg. section 1.1502-32.

² N.Y. State Division of Tax Appeals, Administrative Law Judge Division, DTA No. 825329 (Jan. 22, 2015). **McDermott Will & Emery** represented the taxpayer in that case.

³ In legislation that generally became effective as of January 1, New York's tax on banking corporations was merged into its tax on general business corporations.

⁴ Under New York law, ALJ determinations are not precedent and may not be cited in later cases. At the time of this writing, it is not known whether the Department of Taxation and Finance will appeal the ALJ's decision to the tax appeals tribunal.

⁵ See *Dreyfus Special Income Fund Inc. v. New York State Tax Comm'n*, 72 N.Y.2d 874 (1988), holding that the word "presumably" did not give the Department of Taxation and Finance discretion to modify a company's income.

⁶ N.Y. State Tax Law section 1453 (k-1).

⁷ N.Y. State Tax Appeals Tribunal, DTA No. 810951 (1995).

⁸ 157 N.J. 1, 722 A.2d 918 (1999).

⁹ 10 N.J. Tax 447 (1989).

¹⁰ 868 A.2d 1132 (N.J. Super. Ct. App. Div., 2005).

¹¹ 28 N.J. Tax 96 (2014).

¹² Docket No. 132408 (Mass. App. Tax Bd., 1986).

¹³ Treas. reg. section 1.1502-32(e).

¹⁴ [Treas. reg. section 1.1502-19](#).

¹⁵ Docket No. 913 (Maryland Tax Court, 1995).

¹⁶ Docket No. 161893 (Mass. App. Tax Bd., 1994).

¹⁷ California State Board of Equalization, 96-SBE-019-A (1997).

¹⁸ Treas. reg. section 1.1502-32.

¹⁹ 439 Md. 668, 97 A.3d 1092 (2014).

²⁰ [Treas. reg. section 1.1502-13](#).

²¹ 300 N.W.2d 834 (N.D. 1980).

²² 733 So.2d 397 (Ala. Civ. App. 1998), *cert. denied*, 528 U.S. 876 (1999).

²³ See, e.g., *Gutwirth v. Commissioner*, 40 T.C. 666 (1963).

²⁴ Docket No. 206404 (Mass. App. Tax Bd., 1997).

²⁵ Treas. reg. section 1.1502-13.

²⁶ No. CV 96-0560732 (Ct. Sup. Ct., 1998).

²⁷ *Public Citizen v. Dep't of Justice*, 491 U.S. 440, 470 (1989).