

PP-2008-17
4/7/08

STATEMENT OF AUDIT PROCEDURE

ESTABLISHING SUBSIDIARY STATUS FOR PURPOSES OF THE GENERAL CORPORATION TAX AND TAX ON BANKING CORPORATIONS

I. BACKGROUND

On October 4, 1997, the Department of Finance issued final amendments to the Rules of the City of New York relating to the General Corporation Tax and the Bank Tax. The amendments conform to amendments made to the New York State Code of Rules and Regulations relating to the Corporate Franchise Tax and Bank Tax. The proposed amendments were prompted by two state cases, Matter of Racal Corporation and Decca Electronics, Inc. ("Racal"), and Matter of United Parcel Service General Services Co., ("UPS"). The purpose of this Statement of Audit Procedure is to provide auditors guidance as to how to apply the Racal decision in auditing General Corporation Tax and Bank Tax returns for taxable periods ending on or before October 4, 1997.¹

The Racal Decision. Racal was a May, 1993 appellate level decision of the State Tax Tribunal and held that a second-tier subsidiary was a subsidiary for purposes of the State Corporate Franchise Tax. Both the State and City law define a subsidiary as a corporation of which over 50 percent of the voting shares is owned by a taxpayer corporation. The State and City regulations define ownership for this purpose as actual beneficial ownership. In Racal, the parent and grandparent corporations of the subsidiaries in question were both inactive holding companies.

In that case, based on a stipulation that the parent and grandparent corporations had actual beneficial ownership of the second-tier subsidiary the Tribunal concluded that the second-tier subsidiary was a subsidiary for purposes of the tax. The final amendments make it clear that control of a corporation through tiers of stock ownership is not equivalent to actual beneficial ownership for purposes of making a second, or more remote, tier subsidiary a subsidiary for purposes of the tax.

¹ UPS was a December, 1991 ALJ decision that concluded that in calculating the subsidiary capital of a combined group only the subsidiaries of the members of the group with independent nexus to the state were included in the combined subsidiary capital of the group and the subsidiaries of the other corporations in the group were excluded. The final amendments make it clear that subsidiaries of all members of a combined group were included in combined subsidiary capital. Because UPS was an ALJ decision it has no precedential value and the taxpayer may not rely on the result in that case as binding on the Department for open periods.

II. AUDIT PROCEDURE

Racal was a NYS Tribunal decision binding on the Department in appropriate situations for open taxable years ending on or before October 4, 1997.

When auditing General Corporation Tax and Bank Tax returns for years ending on or before October 4, 1997, if the taxpayer has treated only first-tier subsidiaries as subsidiaries for purposes of the tax, auditors should not apply the Racal decision for the purpose of making adjustments based upon the treatment of second or more remote tier subsidiaries as subsidiaries for purposes of the tax.

When auditing General Corporation Tax and Bank Tax returns for years ending on or before October 4, 1997 where the taxpayer has relied on Racal and takes the position that second-tier subsidiaries should be treated as subsidiaries, auditors should proceed as follows:

- The taxpayer must establish that the facts during the years under audit are comparable to those present in Racal, e.g., each of the corporations between the taxpayer and the subsidiary in question is essentially an inactive holding company and the taxpayer has absolute control over:
 - the election and removal of officers and directors of the subsidiary;
 - operational, tax and financial matters regarding the subsidiary;
 - the declaration and payment of dividends from the subsidiary;
 - the sale or pledge of subsidiary stock; and
 - the maintenance of shareholder derivative actions.
- If the taxpayer is not factually comparable to the taxpayer in the Racal case, the auditor should review the return with regard to whether only first-tier subsidiaries are treated as subsidiaries for purposes of the applicable tax and make any necessary adjustments.
- If the auditor is satisfied that the taxpayer is factually comparable to that in the Racal decision, the auditor should review the returns to determine if the taxpayer has treated the subsidiary in question as a subsidiary for all applicable purposes, for example:
 - expenses directly and indirectly attributable to that corporation have been added back,
 - the income from that entity has been excluded, and
 - the value of subsidiary capital attributable to that entity has been included in subsidiary capital subject to the separate tax on subsidiary capital.

If the taxpayer has not treated all subsidiaries consistently, the auditor may make any necessary adjustments required to ensure such consistency by treating second and more remote tier subsidiaries as subsidiaries for all relevant purposes. In lieu of making such adjustments, the auditor may give the taxpayer

the option of withdrawing its position that Racal applies and the auditor may accept an amended return submitted by the taxpayer on which only first-tier subsidiaries are reported as subsidiaries for all relevant purposes

For taxable periods ending after October 4, 1997, taxpayers may not rely on Racal and auditors should make adjustments necessary to ensure that only first-tier subsidiaries are treated as subsidiaries for purposes of the General Corporation Tax and Bank Tax.