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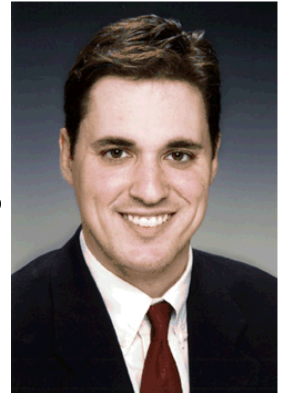
New York's Tax Shelter Initiative -- Score One for the Taxpayer?

by Timothy P. Noonan and Christopher L. Doyle



In 2005, presumably in response to similar action on the federal level, New York's Department of Taxation and Finance and Legislature acted decisively to attack and shut down transactions qualifying for the most odious classification in tax practice: the tax shelter. That action, which was preceded by the tax department's creation of a special tax shelter audit unit, signaled to taxpayers and practitioners that New York was willing to aggressively pursue taxpayers who participated in transactions in which the sole benefit was the reduction of New York taxes. For practitioners, of course, that raised many (or several) concerns about how restrictive New York auditors planned to be when looking at different types of transactions that taxpayers participate in on a regular basis -- many of which are geared toward their tax benefits. The general fear was that New York would become so aggressive that it would effectively prohibit legal and sophisticated tax planning that many taxpayers believe they are entitled to engage in. Moreover, because the new rules created disclosure and reporting requirements, practitioners were also concerned about their own liability and responsibility.

Over the last two years, New York's tax shelter efforts have pressed on, including a voluntary compliance initiative and a more recent proclamation by the tax department of the first New York listed transaction. However, in the Tax Appeals Tribunal's recent decision in *Premier National Bancorp*,[1] the tribunal struck a blow to one effort by the tax department to attack a perceived tax shelter and affirmed the general principle that sophisticated tax planning is still permitted. For taxpayers and practitioners with an eye toward saving taxes, the timing could not be better. In this article, we will discuss the department's recent tax shelter initiatives and how we think *Premier* affects them.

New York's Tax Shelter Initiative

The tax department's 2005 Technical Services Bureau memorandum discussing the new tax shelter rules demonstrated the potentially wide-reaching scope of its efforts.[2] In that memorandum, New York made it clear that it was out to attack any abusive tax avoidance transaction, defined simply as "a plan or arrangement devised for the principal purpose of avoiding tax." The new rules also gave power to the tax commissioner to create New York listed transactions (like federal listed transactions) without being subject to New York state's Administrative Procedure Law. The commissioner simply has to determine that the transaction meets one of the following conditions:

- the transaction is not done for a valid business purpose;
- the transaction does not have economic substance apart from its tax benefits; or
- the tax treatment of the transaction is based on an elevation of form over substance.

This created initial concerns for a few reasons. First, the definition of abusive tax avoidance transactions appeared so broad that it covered many types of otherwise legitimate tax planning techniques. For instance, taxpayers make S elections for the principal purpose of avoiding the second level of tax normally imposed on C corporations. Is that a tax shelter? Or have you ever invested in triple-tax-exempt municipal bonds simply to avoid tax on a portion of your investment? Is *that* a tax shelter? Those are extreme examples, but they underscore the potentially broad scope of the department's tax shelter powers created by those vague definitions. Also, the department's power to create its own listed transactions gives it the ability to retroactively classify specific transactions as abusive -- and create a host of reporting and disclosure requirements, as well as enhanced penalties and lengthened statutes of limitations. In fact, just recently the department announced its first listed transaction, addressing an allegedly abusive tax planning technique regarding charitable contributions.[3] Taxpayers who may have claimed charitable deductions using some specified methods are already receiving letters demanding immediate disclosure and the filing of amended returns reversing the tax benefits.

***Premier*: A New Hope?**

But in the midst of all that tax shelter activity, *Premier* was working its way through the Division of Tax Appeals, essentially seeking to undermine the fundamental basis of the tax department's tax shelter efforts. The taxpayer in *Premier* was a bank that sought to gain favorable tax treatment on some of its investment activities by carrying out those activities through a subsidiary. Normally, under New York law, subsidiaries of banks are required to be included on the bank's combined bank franchise tax return under article 32 of the Tax Law. There are, however, a few important exceptions to that general rule. For instance, a subsidiary that made an election in 1985 under Tax Law section 1452(d) -- called a grandfather election -- could continue to be taxed as a general business corporation under article 9-A of the Tax Law. That special treatment allows the grandfathered 9-A subsidiary to obtain generally favorable allocation on income from its investment activities while still being allowed to be part of the article 32 banking corporation family.[4] And a separate statutory provision ensures that the article 9-A subsidiary may not be combined with its article 32 parent.[5] Thus, since 1985 many banking businesses -- including the taxpayer in *Premier* -- have taken advantage of that favorable statutory framework by having investment activities carried out in grandfathered article 9-A subsidiaries. And since 1985 that permissible structure had been blessed by the tax department both internally[6] and in various published advisory opinions.

In presenting that matter before the administrative law judge and tribunal, the taxpayer made no secret of the fact that it took those steps to save money and reduce the overall group's tax liability. And it also sensibly distinguished the tax planning efforts it engaged in from the types of transactions and activities that the IRS, courts, and the New York tax department have all frowned on in tax shelter cases. That distinction was stated well by the tribunal in discussing the taxpayer's profit-centered motivations:

> The Administrative Law Judge emphasized that Holding invested in Investment Company for the purpose of making a profit. The profit would necessarily be greater because Investment Company was afforded Article 9-A tax treatment, but the goal of the transaction was to make money. *At no point did petitioner create fictitious losses or deductions to minimize its gains.* As the facts demonstrate, Investment Company made approximately $1.8 million in 1998 and over $11 million in 1999 without any consideration of the tax benefits (emphasis added).

The taxpayer was also able to demonstrate that there was nothing illusory or lacking in economic substance about the transactions engaged in. To the contrary, as the tribunal recognized, the taxpayer acquired the subsidiary in a bona fide third-party transaction; it capitalized it with significant assets, which became the subsidiary's capital, not the taxpayer's; the subsidiary set about a plan of investment designed to make money; and the subsidiary, in its own right, made real profits. In other words, the taxpayer did not seek to claim tax benefits from fake or imaginative transactions. Instead, it *really did* engage in the transactions that created the tax savings. And that made all the difference for the tribunal.

And more generally, at least to these biased observers,[7] the tribunal appears to have recognized that taxpayers can indeed engage in tax planning, even when the primary design is -- yes, you guessed it -- to reduce their taxes.

***Premier* and Tax Shelters**

So does that really affect New York's tax shelter initiative? Recall the department's definition of an abusive tax avoidance transaction. In TSB-M-07(5)I, the department defines it as any transaction "devised for the principal purpose of avoiding tax." My guess is that, like many legitimate tax planning ideas, the primary objective of those taxpayers who made such effective use of grandfathered 9-A subsidiaries wanted to reduce their taxes. According to the TSB-M, those folks would be in trouble. But according to the tribunal, at least the taxpayer in *Premier* was not.

But the comfort to be received by other taxpayers could depend on the types of transactions at issue. *Premier* certainly does not permit taxpayers to reduce their taxes by participating in sham transactions or engaging in activities that lack economic substance solely for the purpose of reducing taxes. Taxpayers engaging in those types of strategies are always going to find themselves in lots of trouble. Nonetheless, the concern with the tax department's new tax shelter efforts was that we would now see new attacks on lots of otherwise legitimate tax planning efforts, even those that were complex and that were designed to reduce taxes. *Premier* gives us some hope that the Division of Tax Appeals will apply a principled, sound, and rational approach to the examination of those complicated tax shelter issues. It certainly will not seek to, as the department apparently has, classify any and all transactions designed to avoid tax as tax shelters.

Given the severe penalties New York's new rules impose on taxpayers and practitioners, that should be music to everyone's ears. So as we enter into this new era of tax shelter issues in New York, don't forget to keep a copy of *Premier* close at hand.

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FOOTNOTES

[1] Tax Appeals Tribunal (Aug. 2, 2007). For the decision, see *Doc 2007-18688* [PDF] or *2007 STT 157-18* .

[2] TSB-M-05(4)I.

[3] TSB-M-07(5)I. Interestingly, that transaction is not a federally listed transaction, although just last month the IRS designated it as a transaction of interest.

[4] Absent that treatment, a New York bank's investment income would generally be subject to a very high allocation percentage.

[5] *See* Tax Law section 1462(f)(2)(iii).

[6] The taxpayer in *Premier* was able to show this via internal departmental correspondence and e-mails obtained under subpoena.

[7] The authors of this article represented the taxpayer in *Premier* and also assist taxpayers to plan their affairs so they are tax efficient.

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