STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MEDTRONIC, INC.	:	DECISION DTA No. 800306
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended April 30, 1979 and April 30, 1980	:	

Petitioner Medtronic, Inc., P.O. Box 1453, 3055 Old Highway 8, Minneapolis, Minnesota 55440, filed an exception to the determination of the Administrative Law Judge issued on July 18, 1991. Petitioner appeared by Morrison & Foerster, Esqs. (Paul H. Frankel, Esq. and Hollis L. Hyans, Esq., of counsel) and Baker & McKenzie, Esqs. (Robert J. Cunningham, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

Both petitioner and the Division of Taxation filed briefs. Oral argument, at the request of petitioner, was held on March 25, 1993, which began the six-month period to issue this decision.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUE

Whether the Division of Taxation properly required Medtronic, Inc. to file franchise tax reports for the fiscal years ended April 30, 1979 and April 30, 1980 on a combined basis with two subsidiaries, Med Rel, Inc. and Medtronic Puerto Rico, Inc.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "1," "12" and "23" which have been modified. We have also made additional findings of fact. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional findings of fact are set forth below.

We modify the Administrative Law Judge's finding of fact "1" to read as follows:

> Petitioner, Medtronic, Inc. (hereinafter "Medtronic"), was incorporated in the State of Minnesota in 1957. Its headquarters were located in Minneapolis, Minnesota and, atall relevant times herein, it has been involved primarily in the manufacturing and marketing of artificial heart pacemakers (hereinafter "pacemaker"). During the years at issue, petitioner's share of the world-wide pacemaker market was approximately 40 percent.[1]
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> In September 1973, Medtronic established a new manufacturing operation in Puerto Rico. The site was chosen to take advantage of the low labor and property costs and also to benefit from both Puerto Rican and United States tax advantages.
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> Medtronic Puerto Rico, Inc. ("MPRI"), a wholly-owned subsidiary of Medtronic, was incorporated in Minnesota in 1973. In return for the contribution of capital, patents and unpatented technology, Medtronic received all the authorized common stock of MPRI. MPRI also subsequently purchased patents from a third party.
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> MPRI began operations in Villalba, Puerto Rico in 1974. It qualified for favorable tax treatment under former section 931 of the Internal Revenue Code, and received a 25-year tax exemption under Puerto Rican law. It had approximately 92 employees during fiscal year 1979 and approximately 126 employees during fiscal year 1980.
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> An artificial electronic pacemaker consists of an implantable pulse generator ("IPG") and one or two leads. The IPG produces electrical impulses which discharge at regular intervals to stimulate the patient's heart. The IPG is usually implanted in the muscles of the patient's upper right chest and leads are necessary to carry the electrical impulses to and/or from the heart. MPRI manufactures leads at its plant in Villalba while Med Rel, Inc. manufactures IPGs in Humacao, Puerto Rico.
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> During the years in issue, MPRI's recruiting and salary administration was done by MPRI's personnel department. MPRI's financial organization performed production accounting and general accounting, and produced monthly reports. It was audited by a local certified public accounting firm in Puerto Rico and used local counsel in Puerto Rico. It owned complete and

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[1] The Administrative Law Judge's finding of fact "1" read as follows:

> "Petitioner, Medtronic, Inc. (hereinafter "Medtronic"), was incorporated in the State of Minnesota in 1957. Its headquarters were located in Minneapolis, Minnesota and, at all relevant times herein, it has been involved primarily in the manufacturing and marketing of artificial heart pacemakers."

This fact was modified to more fully reflect the record.

undivided interest in the patents applicable to its products, procured its own raw materials, had its own quality assurance staff and had a general manager and assistant general managers (although it was never disclosed to whom they were responsible). It trained and certified its own employees.

The majority of MPRI's raw materials were provided by unrelated vendors but routed through Medtronic, for which MPRI paid to Medtronic the cost of the materials plus a markup of five to ten percent.

MPRI sold its finished product to Medtronic, at prices representing a 30 percent discount off the United States list prices actually charged by Medtronic to its customers. The 30 percent discount was based on an historic arrangement between Medtronic and an unrelated third party. During the period in issue the entire output of MPRI went to Medtronic or to related parties.

In 1977, Med Rel, Inc. ("Med Rel") established a new production facility for pacemaker leads in Humacao, Puerto Rico. Med Rel was incorporated in Minnesota in 1977. Medtronic received all shares of Med Rel stock in return for capital contributions, patents and unpatented technology. Med Rel qualified for favorable treatment under section 936 of the Internal Revenue Code and received a 15-year tax exemption under Puerto Rican law. It had 140 employees in fiscal year 1979 and 164 employees in fiscal year 1980.

Med Rel's internal functions were performed locally. They included: purchasing, general management, accounting, training and recruitment, quality assurance and personnel. It used local outside counsel and local outside certified public accountants. Med Rel employed its own general manager and assistant manager. As required by the Food and Drug Administration, it maintained voluminous documentation and was subject to periodic on-the-spot examinations by said administration. These same Food and Drug Administration standards were applicable to MPRI as well.

Med Rel purchased certain of its raw materials from third-party vendors, which were routed through Medtronic at a price of cost plus a five to ten percent markup for handling charges. The major components of the IPGs manufactured by Med Rel were purchased from divisions of

Medtronic. Batteries were purchased from the Energy Technology Division, which had originally acquired its patents and technical knowledge from an unrelated company. The price charged by the Energy Technology Division to Med Rel for batteries was based on the price for which batteries had previously been purchased from this unrelated third party. Hybrid circuitry for Med Rel was purchased from the Micro Rel Division of Medtronic. Prices for the hybrid circuitry had originally been set by the former minority ownership of Micro Rel, who had been compensated in part on the financial performance of Micro Rel.

We modify the Administrative Law Judge's finding of fact "12" to read as follows:

> Med Rel sold IPGs to Medtronic at a discount of 35 percent from the list prices charged by Medtronic to its customers. During the period in issue the entire output of Med Rel went to Medtronic or to related parties. The products manufactured by MPRI and Med Rel displayed the Medtronic trademark (Hearing Tr., p. 232).[2]

Med Rel bore the risk of return of warranted goods under the lifetime warranty that Medtronic began offering its United States customers in late 1979 and early 1980.

The Internal Revenue Service audited Medtronic for the years in issue. An international examiner was included as part of the audit team, but the nature and scope of his activities were not disclosed in the record. The Internal Revenue Service Form 4549, Income Tax Examination Changes, indicated that the income of Medtronic was adjusted for the years ended April 30, 1979 and April 30, 1980 in the area of "amortization of customer base". Said amortization was increased to $90,774.00 for the year ended April 30, 1979 and $268,727.00 for the year ended April 30, 1980. However, the form submitted in evidence was not executed on behalf of

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[2] The Administrative Law Judge's finding of fact "12" read as follows:

> "Med Rel sold IPGs to Medtronic at a discount of 35 percent from the list prices charged by Medtronic to its customers. This price was based on the price of comparable products sold by other pacemaker manufacturers to unrelated distributors as well as the discounts Medtronic granted and received for products it sold to and bought from unrelated third parties. During the period in issue the entire output of Med Rel went to Medtronic or to related parties."

The basis for the price of the components sold by the subsidiaries to petitioner is more fully reflected in our additional finding of fact.

Medtronic. Director of Tax for Medtronic, Donald Kizershot, was vague with regard to his memory of the audit and did not recall specifics of the examination of pricing. He could only assume it was looked at. He also did not recall if there was an examination of intangibles and therefore any impact on pricing.

Medtronic filed corporation franchise tax reports with the State of New York for the years in issue.

Following a field audit of petitioner, the Division of Taxation (hereinafter the "Division") recommended that petitioner file its franchise tax returns for the years involved on a combined basis with Med Rel and MPRI.

The Territorial Clause of the United States Constitution (Article IV, § 3, cl 3) gives Congress plenary power over all matters pertaining to Puerto Rico and other United States possessions. Under the authority of the Territorial Clause, Congress enacted a comprehensive scheme of legislation designed to foster the economy of Puerto Rico. Since 1921, special tax provisions have applied to a United States corporation doing business in Puerto Rico which satisfies certain percentage tests (a "Possessions Corporation"). At all times relevant, Med Rel and MPRI were Possessions Corporations. For taxable years beginning prior to January 1, 1976, a Possessions Corporation could exclude all of its gross income from Federal gross income (Internal Revenue Code former § 931). For taxable years beginning after December 31, 1975, a credit against income derived in the possession replaced the exclusion which had been in existence since 1921. In 1982, Congress modified the percentage tests and clarified what income was derived from possessions' sources, but it did not change the basic underlying purpose of the special tax provisions (IRC § 936[h]).

The New York entire net income basis is initially equal to reported Federal taxable income; this basis is then modified by specific statutorily-provided additions and subtractions (Tax Law § 210). Prior to 1976, New York did not tax the Puerto Rican source income of a Possessions Corporation as that income would have been excluded from Federal taxable income.

We also find an additional fact as follows:

> The audit was commenced in 1981 and covered the years ending April 30, 1979 and April 30, 1980. The auditor looked at petitioner's Federal 1120 allocation workpapers and other supporting documents. He also examined petitioner's Federal consolidated report. The auditor examined the records of petitioner's subsidiaries, including MPRI and Med Rel, Inc., including the Federal 1120's filed by each. The auditor indicated that he did not "audit" the returns, but that he "reviewed" the returns and accepted the information on them. The auditor made no inquiry into whether the transactions between petitioner and its subsidiaries were at arm's length. The auditor was aware that a Federal audit for the periods was ongoing but not yet finalized. Federal audit changes for the prior two years were provided to the auditor by petitioner. The auditor made adjustments for these prior two years as a normal aspect of the audit even though they were not the years at issue in the audit he was conducting (Hearing Tr., pp. 42-43).

On August 13, 1982, the Division issued to Medtronic two notices of deficiency. The first notice pertained to the fiscal year ended April 30, 1979 setting forth a tax deficiency of $32,462.00, plus interest of $11,253.93, for a total balance due of $43,715.93. The second notice pertained to the fiscal year ended April 30, 1980 setting forth a tax deficiency of $140,676.00, plus interest of $36,812.10, for a total balance due of $177,488.10.

It is noted that the parties entered into a partial stipulation of facts executed on July 25, 1989 by counsel for both parties and said stipulation has been substantially incorporated herein with the specific exclusion of references to case law. It is also noted that petitioner filed proposed findings of fact numbered 1 through 17 which have also been incorporated herein with the exception of parts of items 5, 9, 12, 16 and 17 which have been excluded due to the fact that they are conclusory, incomplete and/or irrelevant.

Several members of the boards of directors of both Puerto Rican subsidiary corporations were employees of Medtronic. Their identity was never disclosed. Additionally, the officers of the Puerto Rican subsidiaries were not disclosed on the tax returns submitted into evidence or in testimony. As indicated in schedule E of all the United States corporation income tax returns filed on behalf of Med Rel and MPRI, none of the officers of either corporation were compensated or listed.

The United States Corporation Income Tax Return filed for the fiscal year ended April 30, 1979 on behalf of Med Rel, Inc. indicated in schedule K on page 3 in answer to question H(2)(d) that Med Rel owed $10,230,000.00 to Medtronic during the fiscal year ended April 30, 1979 and that Medtronic owed Med Rel $9,292,498.00 as the "highest amount owed" during the fiscal year ended April 30, 1979. As noted in the item, these amounts represent both loans and accounts receivable/payable. The United States Corporation Income Tax Return filed on behalf of Medtronic Puerto Rico, Inc. for the fiscal year ended April 30, 1979 indicated in the same item in schedule K that Medtronic Puerto Rico, Inc. owed $1,626,541.00 as the highest amount owed to Medtronic during the fiscal year and also indicated that Medtronic owed Medtronic Puerto Rico, Inc. $3,449,015.00 as the highest amount owed during the fiscal year. Once again, these amounts include loans and accounts receivable/payable. Finally, the United States Corporation Income Tax Return filed on behalf of Medtronic Puerto Rico, Inc. for the fiscal year ended April 30, 1980 indicated in the same item under schedule K that MPRI owed Medtronic up to $2,400,232.00 during the fiscal year, while Medtronic owed MPRI up to $6,063,574.00 during the fiscal year, including loans and accounts receivable/payable.

We modify the Administrative Law Judge's finding of fact "23" to read as follows:

> At hearing, petitioner called two expert witnesses. The first was John Simpson, an economist with the accounting firm Price Waterhouse. Mr. Simpson was not involved with the audit of Medtronic by the Internal Revenue Service. He testified that the transactions entered into between petitioner and the subsidiaries were arm's length. He based his opinion on a previous study done at the request of petitioner (which was not submitted into evidence) and also new information provided him shortly before the hearing. Specifically, he testified that the purchases of IPGs and leads from Med Rel and MPRI, respectively, compare favorably with commission arrangements[3] between competing

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[3] The following constitute the "commission" arrangements, which Mr. Simpson collectively treated as a discount from list price of 20 percent (see, Hearing Tr., p. 231):

1. Pacesetter, a pacemaker manufacturer who began to produce pacemakers in the late 1970s and became competitive with Medtronic, distributed its product through Biomet, which would receive a commission of 20 percent of the sales price. The extent of information in the record pertaining to Biomet reveals only that it is a distribution company whose salespeople were former Medtronic employees whose distribution territory was comprised of parts of New York, Pennsylvania, and New Jersey (Hearing Tr., p. 256).

pacemaker manufacturers and their distributors, namely that between a company named Pacesetter and its distributor, Biomet. Mr. Simpson attributed the difference in the commission percentages between the two groups of transactions to the following factors:

> "[t]here are some differences in the transactions. One is a commission arrangement, the other is buy-sell where [petitioner was] selling [sic] from [the Subsidiaries] and selling on to the unrelated customers.
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> "Another difference is marketing intangibles. The products manufactured by [the subsidiaries] had trademarks in the name of [petitioner] whereas the products sold by this Biomet for Pacesetter were Pacesetter named products. Again, I think it went into [sic] the Pacesetter is one of the major players in the industry. That I think [makes] the 34 percent[4] commissions arms' length. It's a

greater number than 20 percent, but, again, there is [sic] a few more functions and slightly different intangible components to go with it that would explain the difference between the 20 and the 34. Basically, again, I think that shows evidence of arms' length pricing" (Hearing Tr., pp. 231-232, emphasis added).

The second expert was John Cronin, Esq., a tax manager at a large accounting firm, who claimed that a unitary business did not exist between Medtronic and MPRI and Med Rel.[5]

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2. Medtronic distributors and vendors retained through the years, with discount percentages ranging from 20 to 40 percent.

3. Medtronic Blood Systems (formerly Kastec), which entered into a distribution agreement with a Scandinavian company to distribute artificial heart valves at a 25 percent discount off of list price.

4. Intermedics and Cardiac Pacemakers, which use either a discount from list or a commission approach ranging from 17 to 25 percent of list price (see, Hearing Tr., pp. 147-149).

[4] Mr. Simpson concluded that 34 percent was a rough weighted average of the discounts received for IPGs sold by Med Rel (35 percent) and the leads sold by MPRI (30 percent) (Hearing Tr., p. 230). We will sometimes refer to these respective discount percentages cumulatively using this 34 percent figure.

[5] The Administrative Law Judge's finding of fact "23" read as follows:

> "At hearing petitioner called two expert witnesses. The first was John Simpson, an economist, who testified that he believed the pricing between Medtronic and its two Puerto Rican subsidiaries was arm's length. He based his opinion on a previous study done at the request of Medtronic and also new information provided to him prior to the hearing. Mr. Simpson was not involved with the audit of Medtronic by the Internal Revenue Service. Neither the study nor any other information was

On cross-examination, when Mr. Simpson was asked to state his reasons for concluding that the difference between 20 percent and 34 percent discounts was justified, he responded:

> "there are some differences in [the two transactions being compared]. Medtronic provided a little bit more marketing activity. There is a difference in intangibles, so the way you could think about that is . . . how many percentages points . . . could you attribute to market intangibles, and, to be honest with you, that could be a complex task.
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> "You could spend a lot of time on that question, but the reason and process I went through is that the bulk of the 14 points would be for marketing intangibles" (Hearing Tr., pp. 249-250).

As to the raw materials purchased by petitioner then sold to the subsidiaries at a markup of 5 to 10 percent, petitioner's only offering to establish arm's-length pricing was the testimony of Mr. Simpson, who stated:

> "I just had to rely on my experience that a markup of five to ten percent is more than adequate to be arms' length.
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> "I have seen other transactions in which that was the magnitude, in that area" (Hearing Tr., pp. 227-228).

We also find an additional fact, as follows:

> At hearing, petitioner also called Mr. Donald Kizershot, petitioner's Manager of Taxation from 1977 through the years at issue (Hearing Tr., p. 111). When asked what standard was used to determine the purchase discounts granted to petitioner by the subsidiaries, he responded:
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> "[t]he pricing arrangement really was based primarily on a historical distributor agreement that [petitioner] had with a company called Picker International,[6] who distributed our products on an international basis for years . . . . The agreement with this third party distributor was that [petitioner] as a manufacturer would sell to [Picker] at a thirty percent discount on cost [sic]. It's the same approach that was used with respect

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> produced in evidence. The second expert was John Cronin, Esq., a tax manager at a large accounting firm, who claimed that a unitary business did not exist between Medtronic and MPRI and Med Rel."

We modified this fact to more fully reflect the record.

[6] These transactions will hereinafter be referred to as the "Picker transactions."

> to establishing the pricing arrangement between [MPRI] and [petitioner]" (Hearing Tr., p. 123).

OPINION

The Administrative Law Judge concluded that:

> "the Division of Taxation properly determined that [petitioner] and its Puerto Rican subsidiaries were engaged in a unitary business within both the constitutional and applicable regulatory framework . . .[thus] [t]he ultimate question of whether, under all of the circumstances of the intercompany
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> relationship in this case, combined reporting fulfills the statutory purpose of avoiding distortion of, and more realistically portraying, true income can now be addressed . . . . In view of the substantial extent and nature of the intercorporate transactions between Medtronic and its two Puerto Rican subsidiaries, it is concluded that combined reporting would result in a more realistic portrayal of true income and avoid distortion" (Determination, conclusion of law "E").

The Administrative Law Judge rejected petitioner's assertion that Federal Form 4549 submitted into evidence (Exhibit "2") which showed no adjustment to income other than amortization of customer base, was dispositive proof that intercompany pricing must have been examined by the Internal Revenue Service and a determination made that pricing between Medtronic and all of its subsidiaries was at arm's length and that, therefore, the separate reports filed by each of the companies more realistically portrays their respective true income. The basis for the Administrative Law Judge's conclusion on this issue was that "there is no consent to said assessment by Medtronic and no final report was entered into evidence" (Determination, conclusion of law "E," emphasis added).[7]

The Administrative Law Judge found that the testimony of Mr. Kizershot:

> "was very vague with regard to his memory of the audit and [that he] could not remember whether or not intercompany pricing was specifically examined by the Internal Revenue Service's audit team. He could only assume that such pricing was examined. Mr. Kizershot also did not remember whether or not there was an evaluation of intangibles and whether it impacted on pricing.

[7]The Form 4549 submitted by petitioner was not final since it was not signed by petitioner.

> "Even assuming that the pricing was found to be arm's length by the Internal Revenue Service, no one factor is determinative of the combination issue [cite omitted]" (Determination, conclusion of law "E").

The Administrative Law Judge determined that the expert testimony of John Simpson:

> "cannot be accorded significant weight since the two studies upon which it was based were not submitted into evidence. Furthermore, the expert witness, Mr. Simpson, was in no way involved with the Internal Revenue Service audit and his conclusion that products sold between
>
> Medtronic and its Puerto Rican subsidiaries were sold at arm's length was based upon specific information provided to him by Medtronic in preparation for the litigation in issue. It is noted that such information was also not placed in evidence in this matter" (Determination, conclusion of law "E").

The Administrative Law Judge rejected the testimony of John Cronin, Esq. because it "was conclusory in nature, lacked a cogent analysis and was of little value in clarifying and analyzing the issues presented" (Determination, conclusion of law "E").

Finally, the Administrative Law Judge distinguished this case from the State Tax Commission's decision in Matter of Digital Equip. Corp. (State Tax Commn., June 28, 1985), where the Tax Commission accepted the 482 audit as proof that the intercorporate transactions were at arm's length prices. The Administrative Law Judge stated that in Digital:

> "the hearing officer was able to make detailed findings of fact with regard to the Internal Revenue Service audit and pricing adjustments for the fiscal years in issue. In fact, there was an in-depth finding of fact with regard to what transpired during the audit and the various methodologies applied by the Service with regard to intercompany purchases and the dialogue which took place between the Service and Digital during the audit period. Those critical findings were absent from the instant matter to the point where no specific conclusions could be drawn from the audit performed by the Internal Revenue Service herein. There was no direct testimony with regard to the audit and petitioner did not even submit the actual final income tax examination changes (Form 4549)" (Determination, conclusion of law "E," emphasis added).

On exception, petitioner contends that 1) there existed no unitary business relationship between itself and its subsidiaries; 2) in the alternative, if a unitary business is found to exist and, therefore, create a presumption that income is not accurately reflected without combined reporting, it has presented evidence sufficient to overcome the presumption; 3) because the tax benefits under Internal Revenue Code § 936 are granted only to the extent that the taxpayer's

income is properly reflected, the fact that a Federal audit of petitioner resulted in no adjustments pertaining to intercompany pricing supports the conclusion that the transactions between petitioner and the subsidiaries were arm's length; and 4) requiring petitioner to file a combined report under section 211.4 is in violation of the Supremacy Clause and, therefore, is unconstitutional.

In response, the Division argues that 1) its determination to require petitioner to report the income of the subsidiaries is consistent with its regulations; 2) a limited Internal Revenue Service audit of petitioner in the period at issue does not preclude the Division from requiring petitioner to file on a combined basis; and 3) Tax Law § 211(4) is not preempted by Internal Revenue Code § 936.

We deal first with petitioner's assertion that there was not a unitary relationship between petitioner and its subsidiaries.

In addressing this issue, the United States Supreme Court in Allied-Signal v. Director, Div. of Taxation (__ US __, 112 S Ct 2251) laid out a broad framework under which a state may or may not require combined reporting:

> "the unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the State's authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State."

The constitutional prerequisite to an acceptable finding of unitary business is a flow of value between the subject entities (Container Corp. of Am. v. Franchise Tax Bd., 463 US 159, 178, reh denied 464 US 909). The Supreme Court has further stated that while the indicia of a unitary business are functional integration, centralization of management and economies of scale, there is no single test for determining whether a unitary business exists; rather, there are a wide range of constitutionally acceptable variations of the unitary business theme (Container Corp. of Am. v. Franchise Tax Bd., supra).

The Division's regulations at 20 NYCRR former 6-2.2(b), effective for the taxable years at issue, state:

> "In deciding whether a corporation is part of a unitary business, the [Division] will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:
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> (i) manufacturing or acquiring goods or property or performing services for other corporations in the group; or
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> (ii) selling goods acquired from other corporations in the group; or
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> (iii) financing sales of other corporations in the group."

We have previously held that the indicia set forth at 20 NYCRR former 6-2.2(b) comport with those enunciated by the Supreme Court (Matter of USV Pharm. Corp., Tax Appeals Tribunal, July 16, 1992). Thus, we will apply this regulation to the facts of this case.

The relevant facts in this case are as follows: MPRI and Med Rel manufactured the two primary component parts of a pacemaker (leads and IPGs, respectively) which were sold exclusively to petitioner and related corporations; the majority of the raw materials necessary to produce these products were purchased by petitioner and sold to the subsidiaries at a markup of five to ten percent; Med Rel purchased other essential component parts manufactured by divisions of petitioner, such as batteries and hybrid circuitry for the IPGs. In light of this relationship between petitioner and its subsidiaries whereby they acquired goods and/or property from each other, and petitioner sold goods acquired from the subsidiaries, we conclude that petitioner and its subsidiaries were engaged in a unitary business (20 NYCRR former 6-2.2[1][i], [ii]).

We deal next with whether petitioner has rebutted the presumption that a combined report is necessary in order to properly reflect income.

Petitioner asserts that the Federal audit for the years at issue is dispositive of this issue.

In Matter of USV Pharm. Corp. (supra), we concluded that the adjustments made by the Internal Revenue Service pursuant to Internal Revenue Code section 482 ("section 482") effectively rebutted the presumption found to exist under Tax Law § 211(4) that petitioner's

New York State tax liability had not been properly reflected, as such adjustments were treated as establishing arm's-length pricing. In light of our holding in USV, petitioner asserts that a Federal audit was conducted for the years at issue and no section 482 adjustments were made as a result of this audit; thus, the transactions with its subsidiaries were at arm's length, and its reported income is accurately reflected. Petitioner states specifically, that:

> "it can't be that taxpayers who originally do not put their pricing on an arms' length basis and have to be adjusted by the Internal Revenue Service are somehow in a better position with New York State than taxpayers who did it right in the first place and had no changes" (Oral Argument Tr., p. 11).

In our opinion, establishing that as a result of an Internal Revenue Service audit either 1) an adjustment to intercorporate pricing was made (as in the USV case) or 2) the Internal Revenue Service examined intercorporate pricing and concluded that that no adjustments were necessary serves the same purpose -- it establishes the price that the Internal Revenue Service has determined to be an arm's-length price. In this case, the Federal Form 4549 was not in final form, i.e., signed by petitioner. Moreover, on its face, it does not establish that the transactions between petitioner and the subsidiaries were examined by the Internal Revenue Service. Finally, at hearing, Donald Kizershot, petitioner's Director of Taxation during the period at issue, could not recall whether the Internal Revenue Service examined petitioner's intercorporate transactions or what financial information was provided during the audit (Hearing Tr., p. 196). As a result, there is no direct evidence to establish that petitioner's transactions with its subsidiaries were examined during the course of the Internal Revenue Service audit. Accordingly, we conclude that the fact of the Internal Revenue Service audit does not prove that these transactions were at arm's length (Tax Law § 689[e]).

We deal next with the issue of whether petitioner has shown, through evidence other than the Federal audit, that the intercorporate transactions were at arm's length, thus, rebutting the presumption that a combined report is necessary to properly reflect income. This is a matter of first impression for this Tribunal, presenting, four square, the issue of what standard we should

apply to evaluate the evidence and testimony introduced by petitioner to prove arm's-length intercorporate transactions in the absence of proof of a Federal audit.

The Division's own regulations provide no guidance as to such standard. Nor do we find guidance from the Division's position in prior cases (see, e.g., Matter of USV Pharm. Corp., supra [where the Division asserted that it is not bound by the Closing Agreement (between USV and the Internal Revenue Service) and that, in any event, the section 482 adjustments made by the Internal Revenue Service do not necessarily result in arm's-length pricing or satisfy the conclusion that, because such adjustments have been made, reporting on a separate basis results in a proper reflection of New York tax liability]).

In the instant case, the Division asserts, broadly, that the testimony of petitioner's witnesses would not suffice under section 482 guidelines, implying that section 482 is the acceptable standard (see, Oral Argument Transcript). Since we have held that section 482 and Tax Law § 211(4) share the common purpose of ensuring the proper reflection of income and the results of section 482 audits have been used to establish arm's-length pricing (Matter of USV Pharm. Corp., supra) and petitioner sought to establish that a section 482 audit had been conducted, we conclude that it is appropriate to apply the section 482 guidelines to the proof offered by petitioner.[8]

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[8]We look to section 482 with full knowledge that the regulations thereunder are applied by the Internal Revenue Service in an audit context, not in the context of an adversarial hearing. We are also acutely aware that the Division conducted its audit with no inquiry whatsoever into the pricing structure between petitioner and its affiliates. As a result, the hearing before the Administrative Law Judge was the first time that the subject on arm's-length pricing was addressed by the parties and as his determination indicates clearly, the Administrative Law Judge's rejection of the testimony was solely on the basis that it was not sufficient to establish that the Federal audit examined intercorporate pricing, and that it was insufficient to prove petitioner's assertion that it was not engaged in a unitary business relationship with its affiliates. The Administrative Law Judge made no analysis of the sufficiency of the evidence to establish arm's-length intercorporate pricing in and of itself.

We are also cognizant of Revenue Procedure 63-10, C.B. 1963-1, 490 which prescribes "guidelines for the proper application of section 482 . . . specifically and solely to cases involving U.S. companies and their manufacturing affiliates located in Puerto Rico." We are also aware of Revenue Procedure 68-22 which directs the IRS to continue to close cases on the basis of the guidelines in 63-10 if the result is more favorable to the taxpayer than the results under section 482. However, for our purposes, 63-10 does not eliminate or in any way mitigate the quality and quantity of proof required of petitioner to show that its transactions with its subsidiaries were at arm's length.

The regulations under section 482 define arm's-length price as the price an unrelated party would have paid under the same circumstances for the same property involved in the controlled sale (26 CFR 1.482-2[e][1][i]). The regulations specify three methods, in order of priority, which must be used to determine an arm's-length price for the sale of tangible property: 1) the comparable-uncontrolled-price method; 2) the resale price method, and 3) the cost-plus method (26 CFR 1.482-2[e][1][ii]). Where none of these three methods can reasonably be applied under the facts and circumstances of a particular case, the regulations authorize the use of any other appropriate method, or variations of such methods, for determining an arm's-length price (26 CFR 1.482-2[e][1][iii]).

Under the comparable-uncontrolled-price method, the arm's-length price of a controlled sale is equal to the price paid in comparable uncontrolled sales (26 CFR 1.482-2[e][2][i]). Uncontrolled sales for purposes of the comparable-uncontrolled-price method include: 1) sales made by the taxpayer to an unrelated party; 2) purchases made by the taxpayer from unrelated parties; and 3) sales made between two unrelated parties (26 CFR 1.482-2[e][2][ii]). Controlled and uncontrolled sales are deemed comparable if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or can be measured and eliminated by making a reasonable number of adjustments to the price of the uncontrolled sales. Some of the differences which may affect the price of property are differences in quality of the product, terms of sale, intangible property associated with the sale, time of sale, the level of the market, and the geographic market in which the sale takes place (26 CFR 1.482-2[e][2][ii], emphasis added; see, Sundstrand Corp. & Subsidiaries v. Commissioner, 96 TC 226, citing Bausch & Lomb v. Commissioner, 92 TC 525, at 585-586).

The crux of the matter is whether the uncontroverted testimony of petitioner's witnesses, when viewed in light of these regulations, provides an acceptable basis for this Tribunal to

conclude that the intercorporate prices at issue were at arm's length. The evidence introduced by petitioner consists solely of the testimony of its tax director, Mr. Kizershot and the testimony of its expert witnesses, Mr. Simpson and Mr. Cronin. We find this testimony insufficient basis for us to conclude that petitioner's intercorporate pricing was on an arm's-length basis.

At hearing, Donald Kizershot, petitioner's Manager of Taxation, when asked about the basis for determining the purchase discounts granted to petitioner by the subsidiaries, responded:

> "[t]he pricing arrangement really was based primarily on a historical distributor agreement that [petitioner] had with a company called Picker International, who distributed our products on an international basis for years . . . The agreement with this third party distributor was that [petitioner] as a manufacturer would sell to [Picker] at a 30 percent discount on cost [sic]. It's the same approach that was used with respect to establishing the pricing arrangement between [MPRI] and [petitioner]" (Hearing Tr., p. 123).

Petitioner did not submit the Picker agreement into evidence.

Through this testimony, petitioner, in effect, argues that the price of the Picker transactions constitutes a comparable uncontrolled price ("cup"). Reference to the regulations under section 482 shows that a cup exists only if "the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales," or if "nearly identical," then any differences must be shown not to cause an understatement of petitioner's income (see, 26 CFR 1.482-2[e][2][ii]). However, petitioner has not asserted, much less proved, that the circumstances in the Picker transactions are identical to the MPRI/Med Rel sales to petitioner.

For instance, petitioner failed to reveal whether, like the components that it purchased from its subsidiaries, the pacemakers sold to Picker International bore the Medtronic trademark. This factor would logically impact price, as noted by petitioner's witness, Mr. Simpson, in his comparison of petitioner's purchases to those of Biomet, given petitioner's roughly 40 percent share of the world-wide pacemaker market during the years at issue. Applying the logic of Mr. Simpson's testimony, if the pacemakers sold to Picker did contain the Medtronic trademark, there is a likelihood that this factor would cause the "discount from list" pricing under the Picker transactions to be less than that of the transactions at issue, as the trademark was owned by the

seller in the former case and the purchaser in the latter. However, petitioner has not discussed the trademark factor in the Picker transactions, much less explained the impact of the trademark on the two prices. Further, while it is known that the MPRI-Medtronic agreement was nonexclusive and that Picker distributed primarily outside of the United States, petitioner failed to reveal that such circumstances were similar or different in the counterpart transactions, nor did it state that such differences, if existing, would not affect price (see, 26 CFR 1.482-2[e][2][ii]).

In sum, we find that petitioner has not established that the unadjusted price of the Picker transactions can be considered an uncontrolled comparable price in determining whether petitioner's purchases from its subsidiaries were at arm's length (see, 26 CFR 1.482-2[e][2][ii]). Therefore, we conclude that petitioner's direct evidence does not establish that the purchases by petitioner from MPRI/Med Rel were at arm's-length prices.

John Simpson, an economist with the accounting firm Price Waterhouse and petitioner's expert witness, testified that the purchases of IPGs and leads from Med Rel and MPRI, respectively, compare favorably with commission arrangements between competing pacemaker manufacturers and their distributors, namely that between a company named Pacesetter and its distributor, Biomet, under which Biomet received a 20 percent commission. Mr. Simpson attributed the difference in the discount percentages between the two groups of transactions to the following factors:

> "[t]here are some differences in the transactions. One is a commission arrangement, the other is buy-sell where [petitioner was] selling [sic] from [the subsidiaries] and selling on to the unrelated customers.
>
> "Another difference is marketing intangibles. The products manufactured by [the subsidiaries] had trademarks in the name of [petitioner] whereas the products sold by this Biomet for Pacesetter were Pacesetter named products.
>
> "Again, I think it went into [sic] the Pacesetter is one of the major players in the industry. That I think [makes] the 34 percent commissions arms' length. It's a greater number than 20 percent, but, again, there is [sic] a few more functions and slightly different intangible components to go with it that would explain the difference between the 20 and the 34.

> Basically, again, I think that shows evidence of arms' length pricing" (Hearing Tr., pp. 231-232, emphasis added).

On cross-examination, when Mr. Simpson was asked to state his reasons for concluding that the difference between 20 percent and 34 percent discounts was justified, he responded:

> "there are some differences in [the two transactions being compared]. Medtronic provided a little bit more marketing activity. There is a difference in intangibles, so the way you could think about that is . . . how many percentages points . . . could you attribute to market intangibles, and, to be honest with you, that could be a complex task.
>
> "You could spend a lot of time on that question, but the reason and process I went through is that the bulk of that 14 points would be for marketing intangibles" (Hearing Tr., pp. 249-250).

Mr. Simpson's testimony indicates the difficulties recognized in the regulations under section 482 in quantifying the impact that a trademark has on price. The regulations state:

> "the effects on price of differences in intangible property associated with the sale of tangible property, such as trademarks, are normally not reasonably ascertainable [and] such differences would normally render the uncontrolled sales noncomparable" (26 CFR § 1.482-2[e][2][ii][example 2], emphasis added).[9]

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[9] The portion of the regulation appears to have been refined by the Internal Revenue Manual IRM 4233 HB 5(12)4. In relevant part, the Manual provides as follows:

> "Sub-Section: 5(12)4 Intangibles (6-30-89)
>
> "(1) Section 4 of REV. PROC. 63-10 covers the meaning and significance of intangibles in Puerto Rican allocation cases. An income-producing intangible is present when the intangible can be said to produce an amount of profit which exceeds the profit that would have been realized in the absence of such intangible. For example, income-producing intangibles would be present if:
>
> "(a) a firm developed a patent which prevents other firms from competing on an equal footing;
>
> "(b) a protected trademark with widespread consumer acceptance is involved; or
>
> "(c) a firm discovered a technical skill which, though not patented, is unknown to competitors and can be copied only imperfectly.
>
> "(2) If a product is sold by the island affiliate to the mainland affiliate and such product bears a trademark, trade name, or similar income-producing selling intangible belonging to the mainland affiliate, such sales will normally be compared with sales made under similar circumstances of comparable products to which no selling intangible relates. However, such sale may be compared to independent sales of products with selling intangibles if the value of such selling intangibles is reasonably ascertainable. In the latter case the price of the independent sales will be reduced by the value of the use of such intangible. In the absence of sales of comparable products with or without intangibles, some other pricing method should be used."

"Even when the general methodology of a highly qualified expert witness is accepted, the expert's ultimate conclusion may be rejected if the record does not support that conclusion" (Matter of Bernstein, Tax Appeals Tribunal, December 24, 1992, citing Owensby & Kritikos v. Commissioner, 819 F2d 1315, 87-2 USTC ¶ 9390, at 89,055). Here, as in the Bernstein case, the opinion of the expert (that petitioner's purchases from its subsidiaries were arm's length) "amounts in part to a conclusion of law which we are not bound to accept (see, Estate of Wallace v. Commissioner [95 TC 525, affd 965 F2d 1038, 92-2 USTC ¶ 50,387, reh denied 977 F2d 600]; cf., Matter of Clark, Tax Appeals Tribunal, September 14, 1992; Matter of Niagara Frontier Servs., Tax Appeals Tribunal, August 9, 1990 [where the expert testimony relied on concerned physical facts, rather than legal conclusions])" (Matter of Bernstein, supra).

Under the regulations, petitioner's task is to establish that any differences between two transactions being compared "can be measured and eliminated by making a reasonable number of adjustments" (see, 26 CFR 1.482-2[e][2][ii], emphasis added).

In this case, petitioner's expert failed to provide the underlying basis for his conclusion that the differences between the two transactions accounted for the difference between the two prices. Moreover, his attempt to quantify the impact of petitioner's trademark on price consisted of the broad assertion that "the bulk" of the difference in prices was due to "marketing intangibles." In light of this scant attempt at valuing the differences between the transactions being compared and the failure to describe the method utilized to determine this value, we conclude that petitioner failed to establish that the Biomet transactions were comparable uncontrolled sales.

Aside from the trademark issue, petitioner also failed to address other potential differences which could impact price. The extent of information in the record pertaining to Biomet reveals only that it is a distribution company comprised of former Medtronic employees whose distribution territory was limited to various parts of New York, Pennsylvania, and New Jersey, in

contrast to petitioner, who distributed its product world-wide. Without additional facts, it is not obvious to us why, or to what extent geographic sales would cause a disparity in the value of distribution. Even if such a justification existed, petitioner has not shown that this disparity is capable of measurement as required by the regulations (see, 26 CFR 1.482-2[e][2][ii]).

Another example is the issue of commission sales. Mr. Simpson stated that a price adjustment is justified partially by petitioner's outright purchase of leads and IPGs from its subsidiaries, as opposed to the distributor acting merely as a sales agent, where no transfer of ownership occurs. This distinction is significant from a risk standpoint, because a distributor who is merely an agent of the manufacturer can simply return products which become obsolete or otherwise unsaleable, whereas in a "buy-sell" arrangement this risk of loss is transferred to the distributor-purchaser (petitioner), quite possibly justifying the receipt of a larger percentage of the product's list price (see, Sundstrand Corp. & Subsidiaries v. Commissioner, supra, at 364-365). However, Mr. Simpson made no reference to this risk, much less attempt to measure its impact on price.

In our opinion, the broad assertions of petitioner's expert, which were largely unsupported by facts in the record, fail to adequately account for the difference in price between the Pacesetter/Biomet commission transactions and petitioner's purchases from its subsidiaries (see, 26 CFR 1.482-2[e][2][ii]). Therefore, based on our analysis above, we conclude that petitioner has failed to establish an uncontrollable comparable price in its attempt to prove that its purchases of pacemaker components were arm's length.

Subsidiaries' Purchases from Petitioner

Another burden petitioner bore was to show that the subsidiaries' purchases of raw materials and IPG components from petitioner were at arm's-length prices. Again, we find petitioner failed to sustain its burden through either direct evidence or expert opinion. As to the raw materials, petitioner offered no evidence, other than Mr. Simpson's unsupported conclusion that the transactions were "more than arm's length," to establish that the prices paid by the

subsidiaries were at least equal to prices paid in comparable uncontrolled sales (Hearing Tr., p. 227).

Regarding Med Rel's battery purchases from petitioner's Energy Technology Division, petitioner offers no basis for the increase in price from that charged petitioner by its former supplier, Great Batch, other than Mr. Kizershot's broad assertion that the batteries sold to Med Rel were of superior quality. As to Med Rel's purchases of hybrid circuitry from Micro Rel, petitioner offers no comparable uncontrolled sales. Rather, it simply seeks to cast the Med Rel-Micro Rel relationship itself as arm's length by claiming that the management of Micro Rel -- who set the prices -- was compensated based on the performance of their division and, thus, must have charged an arm's-length price for its product. In making this argument, petitioner apparently seeks to cast Micro Rel as operating outside of petitioner's control. The term "controlled," as defined in the regulations under section 482, "includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised" (26 CFR 1.482-1[a][3]). Because Micro Rel is merely a division of petitioner, existing under petitioner's corporate franchise, we find this claim that the Micro Rel transactions were "uncontrolled" to be wholly without merit.

In sum, we conclude that petitioner has failed to establish that the purchases from its subsidiaries, as well as the subsidiaries' purchases from petitioner and its divisions, were at arm's-length prices (see, 26 CFR 1.482-2[e][2][ii]). We also note that petitioner has failed to present evidence in the record tending to show that alternative methods under the section 482 regulations could be applied. Therefore, we conclude that petitioner has not overcome the presumption that failure to report on a combined basis is necessary to property reflect its tax liability under Article 9-A (Tax Law former § 211[4]; Matter of USV Pharm. Corp., supra).

Petitioner contends that because Internal Revenue Code section 936 (hereinafter section 936) effectively shields the income of a Puerto Rican possession from Federal taxation only to the extent that that income of that possession is properly reflected (i.e., not overstated by means of non-arm's length transactions), combined reporting under Tax Law § 211(4) should not be

applied to section 936 corporations. Petitioner argues that because the arm's-length standard is an integral part of both sections 482 and 936, and that petitioner was not required to make any adjustments at the Federal level, this establishes that there is no distortion in this case. We have already found that petitioner failed to show that the intercompany transactions at issue were examined during the Federal audit for arm's-length pricing. Therefore, any further request that we assume the absence of Federal adjustments to these transactions establishes arm's-length pricing under section 936 must also be rejected.

Petitioner next argues that Tax Law former § 211(4), by requiring corporations with Puerto Rican possessions who seek the tax benefits granted by the Federal government under section 936 to pay tax on possession income, "stands as an obstacle to the accomplishment and execution of Congressional objectives," and that such action is, therefore, unconstitutional under the Supremacy Clause (quoting Northwest Cent. Pipeline Corp. v. State Corp. Commn. of Kansas, 489 US 493, citing Hines v. Davidowitz, 312 US 52, 67). This was the same argument made by the petitioner in Matter of Standard Mfg. Co. v. Tax Commn. of the State of New York (114 AD2d 138, 498 NYS2d 724, affd 69 NY2d 635, 511 NYS2d 229, appeal dismissed 481 US 1044). There, the petitioner asserted that Congress sought to induce investment in United States' possessions by granting favorable tax treatment and that former section 211(4) reduces that incentive. The Appellate Division, Third Department rejected this argument, stating:

> "[w]e perceive no such conflict. The power to tax is not conferred by the Federal Constitution but exists independently of it, and it has been well established that the historic police powers of the states were not to be superseded by a Federal act unless such was the clear and manifest purpose of Congress [citations omitted]" (Matter of Standard Mfg. Co. v. Tax Commn. of the State of New York, supra, 498 NYS2d 724, 727).

In light of this clear statement on this question by the New York courts, we reject petitioner's argument under the principle of stare decisis.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioner Medtronic, Inc. is denied;

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

3. The petition of Medtronic, Inc. is denied; and

4. The notices of deficiency dated August 13, 1982 are sustained.

DATED: Troy, New York
September 23, 1993

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner