STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition of **USV PHARMACEUTICAL CORPORATION** for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1978, 1979 and 1980.	: : : : :	DECISION DTA No. 801050

Petitioner USV Pharmaceutical Corporation, c/o Revlon, Inc., 625 Madison Avenue, New York, New York 10022 filed an exception to the determination of the Administrative Law Judge issued on June 27, 1991 with respect to its petition for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1978, 1979 and 1980. Petitioner appeared by Morrison & Foerster, Esqs. (Paul H. Frankel and Hollis L. Hyans, Esqs., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

Both parties filed briefs on exception. Oral argument, at petitioner's request, was heard on January 17, 1992.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether petitioner may properly be required to file New York State franchise tax reports on a combined basis with its wholly-owned subsidiary, USV Laboratories, Inc.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "26" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner, USV Pharmaceutical Corporation, was incorporated in Delaware in 1965 and began doing business in New York in 1966. It is a manufacturer and distributor of ethical pharmaceuticals and related products. During the years 1978, 1979 and 1980, petitioner was a subsidiary of Revlon, Inc.[1] During said years, petitioner had manufacturing facilities in the United States and had subsidiary and affiliated corporations in both the ethical and over-the-counter pharmaceutical markets and in the blood business. Its headquarters were in Tuckahoe, New York.

Prior to 1971, petitioner's product line consisted of purchased products.

In or about 1971, CIBA Corp. and Geigy Pharmaceutical Corp. merged and the United States Food and Drug Administration required the newly constituted CIBA-GEIGY Corporation ("CIBA-GEIGY") to divest itself of certain products.

Petitioner entered into a series of agreements with CIBA-GEIGY to acquire the patents, trademarks and other rights for the pharmaceuticals Hygroton and Regroton and for Chlorthalidone, the principal ingredient in each, for $24,000,000.00 in cash, plus certain patents and intangibles. Hygroton and Regroton are oral pharmaceuticals which are prescribed for the treatment of hypertension. Petitioner did not incur or claim any research and development expenses in connection with the acquired pharmaceuticals, as the products had been developed by CIBA-GEIGY.

USV Laboratories, Inc. ("Labs") is a wholly-owned subsidiary of petitioner and was incorporated in Delaware in 1972.

In 1973, Labs manufactured Hygroton and Regroton under a license agreement granting Labs a royalty of 7½% of petitioner's net sales of the products.[2]

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[1]In 1985, Revlon, Inc. sold petitioner to another pharmaceutical company. By the terms of that sale, Revlon, Inc. remains liable for any franchise tax deficiencies determined for the pre-sale period.

[2]Exhibit "L," Internal Revenue Service memorandum attachment, p. T-76; Exhibit "2," Kalish memorandum, p. 3.

In 1974, petitioner contributed the patents, trademarks and other rights it had acquired for Hygroton and Regroton, as well as its rights to Chlorthalidone, to Labs. No gain or loss was recognized, as the transfer constituted a transfer to a controlled corporation pursuant to Internal Revenue Code § 351.

In 1974, petitioner and Labs entered into two agreements:

(a) under one agreement, petitioner agreed to provide management services and technical assistance to Labs in return for a fee of 2½% of Labs' sales to petitioner; and

(b) under the other agreement, petitioner became the distributor in the United States and Puerto Rico for all products manufactured by Labs, with the exception of sales of such products to the United States government.

During the years at issue, Labs manufactured Hygroton and Regroton, as well as certain other prescription pharmaceuticals, at its plant in Manati, Puerto Rico. Its operations consisted of combining Chlorthalidone with the inactive ingredients of Hygroton and Regroton, blending and formulating the drugs and packaging the finished products. Labs purchased the Chlorthalidone from Istituto Medicamenta S.P.A., an Italian subsidiary of petitioner's parent, Revlon, Inc.,[3] which manufactured the same under a license from Labs.

Labs was a pharmaceutical manufacturer, not a chemical manufacturer. It was not practical for Labs to build a chemical manufacturing plant for the production of Chlorthalidone, as the quantity of the chemical required to manufacture Hygroton and Regroton was too small to justify the large investment necessary for construction of such facility.

Labs sold approximately $1,000,000.00 per year of its production (representing 2% to 5% of total sales)[4] to the United States government and the balance to petitioner.

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[3]Petitioner's Exhibit "2," Kalish memorandum, p. 4, footnote "5"; Tr., p. 212.

[4]Tr., pp. 156 and 200.

Shipments to the United States government were sent directly to the designated governmental facility, while shipments to petitioner were shipped to and stored at petitioner's facilities in Tuckahoe, New York. Labs' invoices for the shipments were usually paid by petitioner within 30 to 60 days. The finished inventory generally had a short stay in Puerto Rico due to the climate, which was adverse for storage of pharmaceuticals. Returned goods were destroyed by petitioner in the United States, but only after Labs' authorization. Labs also authorized credit allowances for such returned goods.

Pricing between petitioner and Labs was arrived at with the assistance of a review by an outside party (the identity of whom is not disclosed in the record) of the functional analysis between petitioner and Labs and after comparing the selling price to the trade and the value of the services performed by petitioner. Consideration was also given to the value of the patents and intangibles owned by Labs. In 1980, for example, prices were set so that the profit split would be 59% to Labs and 41% to petitioner.

Prices paid by petitioner to Labs were established once a year, during the August-November budget period, and remained the same until the budget period in the following year. Even if petitioner increased prices for its customers during the course of a year, the prices it paid to Labs would remain the same.

Prices for Labs' sales to the United States government were within 3% to 4% of prices Labs charged petitioner.

All of Labs' real property and tangible personal property were located in Puerto Rico.

Labs had its own employees, personnel department, payroll department, pension plan and educational assistance programs, as well as its own purchasing department, accounting department, quality control department and outside counsel. Labs had a union, while petitioner's employees were not unionized. Labs did not have a sales or marketing staff. With the exception of the sales made to the United States government, sales of Labs' products were handled by petitioner's sales and marketing staff. Petitioner had a marketing group and also had a pharmaceutical detail force, with sales personnel calling on the medical profession in order to induce physicians to prescribe the drugs in petitioner's product line, including Hygroton and Regroton.[5] As stipulated[6] by the parties, Labs conducted no business in New York State and had no real or personal property, employees or activities in, or any contact with, New York State and conducted all of its business in Puerto Rico.

Petitioner's business locations during 1978, 1979 and 1980 were as follows:[7]

Location	Facility
Tuckahoe and Yonkers, New York	Plant; Research; Administrative Office; Warehouse
Ramsey, New Jersey	Warehouse
Tustin, California	Warehouse; Sales Office (1979)
Carolinas, Puerto Rico	Warehouse; Office
Earth City, Missouri	Warehouse; Sales Office (1979)
Atlanta, Georgia	Sales Office (1979)
Dallas, Texas	Sales Office (1979)
Chicago, Illinois	Sales Office (1979)
Paris, France	Administrative Office
Michigan	Sales Office (1979)
Hong Kong	Sales Office (1979)

(1979)

In conjunction with an Internal Revenue Service audit (infra), the Internal Revenue Service pharmaceutical industry coordinator, after a tour of Labs' facilities in 1984, stated in his trip report (in part):

> "Material requirements and product planning initiates with the receipt of forecasts from the marketing officials in the headquarters company."[8]

Petitioner's response to the trip report included the following:

> "USV Tuckahoe is the contract distributor for [Labs'] products. As such, it is standard business practice for distributors to furnish sales volume forecasts. It should be noted that all production planning, scheduling, material requirements,

[5]Tr., p. 149.

[6]Exhibit "O," Stipulation, p. 2.

[7]Exhibit "O," Stipulation, p. 4.

[8]

Exhibit "I," p. 1 (p. T-138).

> purchasing, purchasing contracts and schedules as well as invoicing and payment is done by [Labs]."[9]

Prior to 1976, Labs qualified for the exclusion of income from sources within possessions of the United States provided for under Internal Revenue Code former § 931. Effective in 1976, the exclusion for domestic corporations was replaced by the Puerto Rico and Possession tax credit under Internal Revenue Code § 936, created by the Tax Reform Act of 1976 (P.L. 94-455). Labs qualified for the credit in 1976 through the years at issue, and also qualified for certain Puerto Rico tax exemption grants. In fact, Labs had been incorporated in the United States rather than Puerto Rico to take advantage of these favorable tax consequences

The Federal Audits

Petitioner was audited by the Internal Revenue Service for every year from 1972 to 1983 as part of an audit of petitioner's then parent corporation, Revlon, Inc., its subsidiaries and affiliates.

For the audits covering 1972-74 and 1975-76, the Internal Revenue Service proposed to redetermine selling prices of products sold by Labs to petitioner pursuant to Internal Revenue Code § 482, which provides for allocation of income and deductions among controlled taxpayers. The proposal was to recalculate the selling prices on the basis of Labs' costs, plus 25%. No markup was to be permitted on the marketing fee paid by Labs to petitioner (apparently the 2½% fee for marketing services and technical assistance noted above).

Petitioner challenged the proposal, claiming that Labs was being treated as a mere contract manufacturer and that the adjustments took no account of the patents, trademarks and other intangibles which Labs had acquired in 1974, and allowed no element of profit to Labs reflecting such ownership.[10] A request for technical advice

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[9] Exhibit "J," p. 1.

[10] Exhibit "3," Kalish letter, p. 3.

was made to the Internal Revenue Service National Office. The request was accepted, but was apparently held in abeyance pending a Federal court decision involving section 482.[11]

On or about February 27, 1989, an Internal Revenue Service National Office Technical Advice Memorandum[12] was issued with respect to the proposed adjustments for the years 1974, 1975 and 1976. The issue stated in the memorandum was as follows:

> "Whether the Commissioner may, under the authority of I.R.C. § 482, disregard [petitioner's] transfer in [1974], under section 351, of a patent, that it purchased for cash in [1971], to its wholly owned Puerto Rican subsidiary, [Labs], allow the subsidiary essentially a return on its manufacturing costs, and allocate the balance of the subsidiary's income to [petitioner]."

After a lengthy statement of facts and a discussion of the law, the memorandum offered the following conclusions:

> "As to [1974, 1975 and 1976], we think the section 351 transfer of the drug patents to [Labs] must be recognized. This case does not, as far as we know, involve the transfer of appreciated property, or the use of a nonrecognition provision to split-off income from the expenses incurred in producing the income. Any section 482 income allocation for [1974 through 1976] must be based on the factual determination that [Labs'] sale prices to
> [petitioner] were other than at arm's length, having concluded that [Labs] owned the intangibles in question."

The case was then remanded to the Appellate Division of the Internal Revenue Service where it was ultimately conceded that there would be no section 482 adjustments for the years 1974-1976.[13]

Meanwhile, a different Internal Revenue Service team conducted an audit for the years 1977 through 1979. The section 482 adjustment issue was raised, and on April 12, 1984, the Internal Revenue Service pharmaceutical industry coordinator and the audit case manager

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[11] Eli Lilly & Company v. Commissioner, 856 F2d 855 (7th Cir 1988).

[12] Exhibit "4."

[13] Tr., p. 171. The reference in the transcript to "May of 1980" would appear to be incorrect, as the Technical Advice Memorandum was not issued until February 27, 1989. Also see petitioner's brief, p. 14. According to petitioner, the audit for 1974-1976 was resolved four and one-half years after the audit for 1977-1980 because the Appellate Conferee handling the earlier years would not accept the provisions of the closing agreement executed July 6, 1984. Tr., p. 187.

inspected Labs' facilities in Manati, Puerto Rico. The issue was resolved on July 6, 1984, when Revlon, Inc., petitioner and the other affiliated corporations involved in the audit entered into a closing agreement[14] with the Internal Revenue Service which increased petitioner's taxable income and reduced Labs' income by the following amounts of Internal Revenue Code § 482 adjustments:

Year	Amount of Adjustment
1977	$2,495,000.00
1978	2,053,000.00
1979	1,154,000.00[15]

Petitioner concedes that the prices reflected in the adjustment were 7% to 8% greater than the prices paid by petitioner.

We modify finding of fact "26" of the Administrative Law Judge's determination to read as follows:

> The closing agreement between petitioner and the Internal Revenue Service provides that:
>
> "[t]he method for deriving the Section 482 pricing adjustment is a cost sharing arrangement of the type applicable under Section 936(h) for post-TEFRA years and is derived by taking into account U.S. and Puerto Rico activities. The method is described in Schedule B attached hereto and made a part hereof" (Closing Agreement, ¶ '[c]').
>
> Schedule B provides, in relevant part, as follows:
>
> "I. <u>COMBINED PRE-TAX PROFIT</u>. First, a combined pre-tax profit ('Combined PBT') is calculated for each calendar
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> year for each Product manufactured in Puerto Rico. The Combined PBT for each Product is the combined profit before tax derived by USV and Labs, USV and Development, or Norcliff and Development, whichever combination is applicable, from sales of the Product to third parties, other than the U.S. government.

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[14]The agreement was executed on behalf of Revlon, Inc. and its subsidiaries by Stanley B. Dessen, as Vice President-Taxation of Revlon, Inc. and as Vice President of each subsidiary, on June 26, 1984 and was executed on behalf of the Commissioner of Internal Revenue on July 6, 1984.

[15]

Exhibit "K," closing agreement, p. 2.

"The following items are taken into account in arriving at the Combined PBT of each Product and are computed as described:

"1. Sales. Sales are made up of all third party sales by the U.S. Company less discounts, returns and allowances of the Product.

"2. Cost of Goods. The cost of goods, which is used for financial reporting purposes, is the standard FIFO cost with variances based on the specific identification of the Product sold by the U.S. Company to third parties.

"3. Advertising. Advertising costs are all advertising costs specifically related to the Product and directly allocated thereto.

"4. Marketing. Marketing costs consist of the U.S. Company's period marketing costs (e.g., salaries of marketing personnel and other costs of the marketing department). The following allocation fraction is used for marketing costs:

$$\text{Marketing Costs} \times \frac{\text{Third Party Sales of the Product}}{\text{All Sales of the U.S. Company}}$$

"5. Selling. Selling costs, consisting of direct selling expenses (e.g., salesmen's expenses) and period selling expenses (e.g., salaries of the administrative staff) of the U.S. Company are included in the adjustments described in the Closing Agreement with Revlon, Inc. Beginning in 1980 and thereafter, selling costs are allocated to each Product by the percentage of sales method described above for marketing.

"6. Distribution. Distribution expenses of the U.S. Company, consisting of direct distribution expenses (e.g., freight and postage) and period distribution expenses (e.g., salary of the distribution manager), are allocated to each Product by the percentage of sales method described above for marketing. Distribution expenses of the 936 Company are allocated to each Product by the following fraction:

$$\begin{array}{c}\text{Distribution}\\\text{Expenses}\end{array} \times \frac{\text{Sales of the Product to the U.S. Company}}{\text{All Sales of the 936 Company}}$$

"7. General and Administrative. G&A expenses of the U.S. Company are allocated to each Product by the percentage of sales method described above for marketing. G&A expenses of the 936 Company are allocated to each Product by the percentage of sales method described above for distribution.

"8. R&D. Direct R&D (i.e., Phase IV) is allocated to the Product for which the research is done.

"9. Amortization. The cost of the patent to manufacture chlorthalidone, an ingredient of Hygroton/Regroton, is amortized over its useful life through 1979, when the patent expired.

"II. PBT PER 936(h). The following adjustments are made to the Combined PBT to arrive at an amount equivalent to a fully loaded 'PBT Per 936(h).'

"1. R&D Adjustment. Direct R&D and patent amortization are eliminated from expenses, and '936(h) R&D' is added as an expense. The following allocation fraction is used to arrive at 936(h) R&D:

$$\text{SIC Code 283 R\&D of the Affiliated Group} \times \frac{\text{Possessions Sales (Excluding Sales of Purchased or Exchanged Products)}}{\text{SIC Code 283 Worldwide Sales}}$$

"2. Headquarters. The following fraction is used to allocate the headquarters expense of the Revlon Health Care Group ('RHCG') to each Product:

$$\text{RHCG Headquarters Expense} \times \frac{\text{Third Party Sales of the Product}}{\text{Total RHCG Sales}}$$

"3. Interest. The following fraction is used to allocate USV interest to all Products:

$$\text{USV Interest} \times \frac{\text{Labs and Development Manufacturing Assets}}{\text{USV, Labs, \& Development Manufacturing Assets}}$$

"The interest allocation for all Products is further allocated to each Product based on the third party sales of each Product.

"III. PUERTO RICO PBT REPORTED. The Section 482 pricing adjustment is made with reference to the Puerto Rico PBT Reported. The 'Puerto Rico PBT Reported' is the Puerto Rico component of Combined PBT described under paragraph I above computed as follows:

"The Puerto Rico sales amount is the transfer price of the Product from the 936 Company to the U.S. Company for the Product sold by the U.S. Company to third parties. This transfer price is the amount deducted by the U.S. Company as cost of goods sold on the U.S. consolidated Federal income tax return with respect to the Product. The Puerto Rico cost of goods is the standard FIFO cost with variances based on the specific identification of the Product sold by the U.S. Company. The Puerto Rico expenses consist of all expenses paid by the 936 Company (including a management fee to the U.S. Company equal to 2 1/2% of sales made by the 936 Company to the U.S. Company) and the patent amortization" (Closing Agreement, pp. 1 of 5 - 5 of 5).

The adjustment was then calculated as follows:

(i) The parties agreed that 43.5% of combined pre-tax profit was attributable to petitioner and 56.5% was attributable to Labs.

(ii) The section 482 pricing adjustment was the difference between the amount attributable to Labs and Labs' pre-tax profit reported.

(iii) The difference reduced petitioner's cost of goods sold reported for the products and increased petitioner's taxable income by the same amount.

The closing agreement stipulated that it was to "be extended to encompass the taxable years 1980, 1981, 1982, 1983, and subsequent years to the extent that any pre-TEFRA inventory (as defined in proposed regulations under section 936[h]) is sold to third parties.[16, 17]

16

Exhibit "N," Federal Income Tax Examination Changes for 1980-1982, shows section 482 adjustments for said years as follows:

Year	Adjustment
1980	$ (182,000.00)
1981	2,554,000.00
1982	3,361,000.00

The negative adjustment for 1980 would seem to indicate that petitioner actually overpaid for its 1980 purchases.

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The original finding of fact "26" of the Administrative Law Judge's determination read as follows:

"The agreed-upon Internal Revenue Code § 482 adjustments were derived from an analysis which may be summarized as follows:

"(a) A combined pre-tax profit for each product manufactured by Labs was determined from the combined profit before taxes of petitioner and Labs from sales of the product to third parties other than the United States government.

"(b) The combined pre-tax profit was adjusted "to arrive at an amount equivalent to a fully loaded [pre-tax profit] per 936(h)," referring to Internal Revenue Code § 936(h), which sets forth tax treatment of intangible property income.'*'

"(c) The Puerto Rico pre-tax profit reported was then calculated by taking the transfer price (the amount deducted by petitioner as cost of goods sold) and deducting Labs' cost of goods and other expenses, including the 2½% management fee paid to petitioner and patent amortization.

"(d) The adjustment was then calculated as follows:

"(i) The parties agreed that 43.5% of combined pre-tax profit was attributable to petitioner and 56.5% was attributable to Labs.

"(ii) The section 482 pricing adjustment was the difference between the amount attributable to Labs and Labs' pre-tax profit reported.

"(iii) The difference reduced petitioner's cost of goods sold reported for the products and increased petitioner's taxable income by the same amount.

"(e) The closing agreement stipulated that it was to "be extended to encompass the taxable years 1980, 1981, 1982, 1983, and subsequent years to the extent that any pre-TEFRA inventory (as defined in proposed regulations under section 936[h]) is sold to third parties.'**'

In a report prepared for submission to the visiting Internal Revenue Service pharmaceutical industry coordinator on April 12, 1984,[18] Labs and another subsidiary of petitioner, USV (P.R.) Development Corporation, were referred to, collectively, as "USV-PR". It was stated that both corporations had qualified under Internal Revenue Code § 936 for treatment as possessions corporations.

While the point was not explained or raised at the hearing, the report indicates that both subsidiaries used the Manati plant and shared the same personnel. The two corporate entities seem to have been divided between product lines, with Labs manufacturing Hygroton and Regroton, as well as the pharmaceuticals Arlidin and Pertofane, and USV (P.R.) Development Corporation manufacturing Doriden and A-200 Pyrinate. The report stated, in part:

> "Each company has a separate tax exemption grant which covers particular products. An application for a third grant of tax exemption has been applied for by USV Labs.

"'*' It is unclear why the closing agreement refers to section 936(h) with respect to the years at issue, as said subdivision was added by P.L. 97-248 and generally applies to tax years beginning after 1982. Petitioner maintains that the adjustments were actually made pursuant to section 482 and further, that even if the adjustments had been made pursuant to the principles of section 936(h), the result would be no different, as the method used under section 936(h) is one of the same methods used under section 482 (see: Petitioner's Reply Brief, p. 10).

"'**' Exhibit 'N,' Federal Income Tax Examination Changes for 1980-1982, shows section 482 adjustments for said years as follows:

Year	Adjustment
1980	$ (182,000.00)
1981	2,554,000.00
1982	3,361,000.00

"The negative adjustment for 1980 would seem to indicate that petitioner actually overpaid for its 1980 purchases."

We modified this fact to set forth fully the methodology utilized in arriving at the section 482 pricing adjustment.

[18]Exhibit "I."

> The third grant will be transferred to a separate corporation, USV Products, Inc."[19]

Distinguishing the section 936 subsidiaries is even more difficult after review of memoranda[20] submitted to the Internal Revenue Service in connection with the audit for the years 1972-1976, which refer to an entity named USV Pharmaceutical Manufacturing Corporation as "USV-PR." From the context of the memoranda, it appears that USV Pharmaceutical Manufacturing Corporation could actually be Labs. However, the Technical Advice Memorandum specifically refers to Labs by name. Neither USV Pharmaceutical Manufacturing Corporation nor USV Products, Inc., is referred to in the Technical Advice Memorandum.

The New York State Audit

Petitioner filed its New York State corporation franchise tax reports for the calendar years 1978, 1979 and 1980, computing its tax based on allocated capital, and, after utilizing tax credits, paid $250.00 minimum tax for each year.

A number of adjustments were made upon audit by the New York State Division of Taxation. However, after a conference in the former Tax Appeals Bureau, only one issue remained: that of combined reporting. The auditor had determined that petitioner was required to file combined franchise tax reports with Labs. The basis for this determination is stated in the field audit report:

> "It was determined on audit that taxpayer should be filing on a combined basis with its wholly owned subsidiary, USV Laboratories, Inc. (66-0313587)[.] USV Laboratories is a Puerto Rican Company that was incorporated in Delaware on June 30, 1972. It's [sic] business group code number is 2830 and the corporation's address is: P.O. Box 345, Manati, Puerto Rico 00701.
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> USV Laboratories manufactures ethical pharmaceuticals and 80% of their sales are attributable to the previously mentioned product Hygroton. The subsidiary holds its own patents and they are currently the only manufacturer of this product. The subsidiary does not have its own sales force but sells its products directly back to

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[19] Exhibit "I," unnumbered footnote to Section "I," Overview.

[20] Exhibits "2" and "3."

> the parent who then sells it in the United States. The taxpayer [sic] obtains the bulk of its raw materials from overseas.
>
> The taxpayer and its subsidiary are part of a unitary business. All requirements for combined reporting are met. These include ownership, substantial intercompany transactions and a unitary business. For all of these above mentioned reasons the subsidiary USV Laboratories is being required to file on a combined basis with its parent USV Pharmaceutical Corporation beginning with calendar year ended 1978.
>
> Transactions between the taxpayer and its other subsidiaries are not substantial enough to require combined reporting."[21]

It is noted that prior to 1976, Puerto Rico source income of a domestic corporation was not taxed in New York, as said income was excluded from Federal taxable income by virtue of Internal Revenue Code former § 931. In 1976, when the exclusion was replaced by a credit under Internal Revenue Code § 936, the Puerto Rico source income was no longer excluded from Federal taxable income and thus could be subjected to New York tax.

At the hearing, the audit team leader admitted that no examination had been made as to whether there was functional integration between petitioner and Labs, whether any economies of scale existed, or whether there was common purchasing, common advertising, unity of use or unity of operation. He also conceded that no inquiry had been made as to whether there was arm's-length pricing between petitioner and Labs, or as to the degree of independence with which Labs operated.

Petitioner executed a series of consents extending the period of limitation on assessment for the years 1978 and 1979 to January 31, 1984. On December 16, 1983, statements of audit adjustment and notices of deficiency were issued to petitioner asserting tax and interest due as follows:

Period Ending	Tax	Interest	Total
12/31/78	$558,652.00	$325,855.44	$884,507.44
12/31/79	409,768.00	202,935.98	612,703.98

The recomputation of tax was based on application of the tax rate to the

21 Exhibit "S," field audit report, pp. 3-4.

allocated combined entire net income of petitioner and Labs. The combined business allocation percentages used on audit were:

Year	Percentage
1978	36.9437%
1979	32.0346%
1980	34.5344%

The deficiencies in tax were the amounts due after the allowance of investment tax credits of $218,650.00 for 1978 and $346,456.00 for 1979 and a DISC export credit for 1978. No statement of audit adjustment or notice of deficiency was issued for the year 1980, as tax liability calculated upon audit was eliminated by an investment tax credit of $478,295.00 allowed for said year.

The following adjustments were made pursuant to the aforementioned Tax Appeals Bureau conference:

(a) The DISC export credit was recomputed based upon shipments from New York. This resulted in a $36.00 credit for 1979 and a $110.00 credit for 1980.

(b) For 1979, petitioner's investment allocation percentage was adjusted to reflect an issuer's allocation for private export funding of 100%, not 0% as originally claimed. Accordingly, allocated investment income for 1979 was reduced from $457,380.00 to $373,207.00.

(c) While it was not mentioned in the Report of Tax Conference, it appears from the workpapers that a minimum tax on combined subsidiary of $250.00 per year was eliminated in the recalculation after the conference.

(d) Additional tax due for each year was recomputed as follows:

Period Ended	Additional Tax Due
12/31/78	$558,402.00
12/31/79	401,065.00
12/31/80	-0-

Additionally, the investment tax credit charged against 1980 was reduced from $478,295.00 to $477,935.00, a difference of $360.00. This evidently represents the $110.00 DISC export credit and $250.00 minimum tax on combined subsidiary.

Audit Policy As To Combined Reporting

In 1984, the Combined Policy Subcommittee was formed within the Audit Division of the Division of Taxation for the purpose of reviewing issues related to combined reporting and making policy recommendations. The subcommittee consists of representatives from the District Office Audit Bureau, the Central Office Audit Bureau and, from time to time, the Audit Evaluation Bureau.

Prior to the Decision of the State Tax Commission in Matter of Digital Equipment Corp. (State Tax Commission, October 14, 1985), audit policy was to require combined reports where there was a final Federal determination with Internal Revenue Code § 482 adjustments for transactions with a section 936 corporation. The committee interpreted Digital as holding that Federal changes under section 482 would cure any presumed distortion created by intercompany transactions. Consequently, although the Audit Division did not agree with the holding in Digital, audit policy was changed and it was decided not to pursue combination in such cases. However, the policy question surfaced again, after the decision of the Court of Appeals in Campbell Sales Company v. New York State Tax Commission (68 NY2d 617, cert denied 479 US 1088). In early 1987, after Campbell, the Audit Division requested Counsel for the Department of Taxation and Finance to advise whether Digital or Campbell should be followed. Sometime in 1988, an opinion of Counsel advised that Campbell was controlling. Since that time, audit policy has been to require combination in cases involving taxpayers with section 936 subsidiaries and section 482 adjustments,[22] where more than 50 percent of transactions are intercorporate and the business is deemed unitary. It appears, however, that although notices of deficiency have been issued in some such cases, most

[22]The Division of Taxation acknowledges that Campbell did not involve a section 482 adjustment or a section 936 corporation.

of the cases are still open, with consents extending the period of limitation on assessment having been obtained where the period would have otherwise expired.[23]

The parties have stipulated that if the position of the Division of Taxation is ultimately sustained, petitioner is entitled to a reduction of the deficiencies consistent with the Administrative Law Judge determination in Matter of Belding Heminway Co., Inc., (Division of Tax Appeals, September 9, 1988). Said case held that intercompany charges for administrative services and other specialized services did not constitute business receipts. Application of such rule to this case would reduce the receipts factor and additional receipts factor for each year as follows:[24]

Year	Existing Receipts Factor and Additional Receipts Factor	Reduced Receipts Factor and Additional Receipts Factor
1978	11.6865%	8.8987%
1979	10.4986%	7.6898%
1980	14.2020%	7.6336%

This would reduce the deficiencies for 1978 and 1979 by $28,620.00 and $31,150.00, respectively, and increase the income tax carry forward for 1980 by $36,702.00.[25]

OPINION

The Administrative Law Judge determined that the Division of Taxation's (hereinafter the "Division") current regulations were applicable to the periods at issue and that petitioner met the capital stock and unitary business requirements of the statute and the regulations and engaged in substantial intercorporate transactions. The Administrative Law Judge determined that:

> "[t]he New York Law . . . seems to be that while it is not a condition precedent that income or capital of a taxpayer be improperly or inaccurately reflected before the Division of Taxation may exercise its discretion and require combined reports because of intercorporate

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[23]As pointed out by petitioner, Digital was cited in an Advisory Opinion of the Commissioner of Taxation and Finance issued after 1988 (United States Surgical Corporation, Advisory Opinion, January 31, 1989, TSB-A-89[2]C).

[24]Petitioner's Exhibit "5."

[25]Id.

> transactions (Wurlitzer and Campbell), the courts will determine whether, under all of the circumstances of the intercompany relationship, combined reporting will avoid distortion and more realistically portray true income (Coleco and Standard)" (Determination, pp. 30-31).

The Administrative Law Judge concluded that petitioner failed to sustain its burden of proof to show that, under all of the circumstances of the intercorporate relationship between petitioner and Labs, reporting on a separate basis would avoid distortion and more realistically portray income. Specifically, the Administrative Law Judge determined that, while petitioner showed that Labs operated with considerable autonomy and that inventory was purchased from Labs at prices "at least close to arm's length, there are numerous factors which weigh heavily against petitioner's position, or which have not been satisfactorily explained" (Determination, p. 32). The Administrative Law Judge concluded that:

> "[w]hile any one of the . . . factors [alone] may not be enough to necessitate combined reporting, taken as a whole, they show the interdependent relationship between petitioner and Labs and that combination of the two entities is essential for portraying the true income of what was virtually one business" (Determination, p. 34, emphasis added).[26]

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26 The factors referred to by the Administrative Law Judge in conclusion of law "N" include:

(1) Intercorporate transactions with petitioner represented 95% to 98% of Labs' sales.

(2) Petitioner was Labs' marketing and sales arm and provided Labs with marketing forecasts, the apparent starting point for the calculation of Labs' production planning and material requirements. Petitioner's sales personnel conducted sales and promotional functions with the medical profession for products manufactured by Labs.

(3) All of Labs' non-governmental production was shipped to petitioner's New York facility for distribution. Returned merchandise was destroyed in New York on Labs' authorization.

(4) Prices paid by petitioner were set annually. Labs received the same price for the year, apparently even if its costs increased during the year, while petitioner was free to increase prices to its customers.

(5) While prices charged to petitioner by Labs were close to arm's length, petitioner concedes that said prices were 7% to 8% less than the adjusted prices set forth in the closing agreement with the Internal Revenue Service.

(6) Petitioner provided management and technical services to Labs for a fee of 2 1/2% of sales.

The Administrative Law Judge went on to state that:

> "[e]ven assuming that the Internal Revenue Service had found prices between petitioner and Labs to have been arm's length, it does not necessarily follow that there would have been no distortion of income and that petitioner's true income would have been portrayed. While there are similarities between Internal Revenue Code § 482 and Tax Law § 211(4), the statutes are clearly distinguishable. The basic aim of Internal Revenue Code § 482 is to examine intercompany transactions to see if they are bona fide, e.g., to determine if the prices and terms in such transactions are truly arm's length (Treas Reg § 1.482-1[c]). The Internal Revenue Service cannot compel a parent and subsidiary to file a consolidated return (Treas Reg § 1.482-1[b][3]). Tax Law § 211(4) is broader, and envisions more than an examination of intercorporate pricing, requiring examination of the entire intercorporate relationship" (Determination, pp. 34-35).

The Administrative Law Judge also determined that requiring petitioner and Labs to file combined New York State Franchise Tax reports does not violate either the Due Process Clause (US Const, 14th Amend, § 1) or Commerce Clause (US Const, art I, § 8, cl 3). He concluded that petitioner failed to sustain its burden of proving that Labs was a discrete business enterprise. Thus, petitioner and Labs constituted a unitary business with sufficient nexus for taxation by New York State (citing Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 US 425).

The Administrative Law Judge also rejected petitioner's claim that, since the Division did not combine certain other taxpayers and their section 936 subsidiaries with section 482 adjustments between the issuance of the Digital decision in 1985 and the 1987 request for an Opinion of Counsel following Campbell, assertion of tax against petitioner denies it equal protection of the law. The Administrative Law Judge concluded that the Audit Division was not administering Tax Law § 211(4) "with an evil eye and unequal hand" (Matter of Dora P., 68

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(7) Petitioner did not show that the two corporations did not share common directors or that Labs' directors were not controlled by petitioner. Petitioner did not identify Labs' senior officers or show that they were independent of petitioner. The material presented to the Internal Revenue Service at the time of the visit to Labs' plant indicates that Labs' highest ranking officer in Puerto Rico was its vice-president and plant manager.

(8) Labs and another subsidiary of petitioner, USV (P.R) Development Corporation, appear to have shared not only the same plant at Manati, Puerto Rico, but the same personnel. The major distinction between the two subsidiaries seems to have been different product lines.

AD2d 719, 418 NYS2d 597, 604) but, rather, was attempting to conduct audits during said period under its interpretation of existing precedent. This was not a violation of the Equal Protection Clause (US Const, 14th Amend, § 1).

Finally, the Administrative Law Judge determined that, in accordance with the stipulation of the parties, petitioner is entitled to a reduction of the deficiencies consistent with the Administrative Law Judge's determination in Matter of Belding Heminway Co. (Division of Tax Appeals, September 9, 1988).

On exception, petitioner reiterates its position at hearing that it should not be required to file a combined report with Labs. Petitioner asserts that the proper standard is that a combined report may only be required by the Division where it is necessary to avoid distortion and to properly reflect income. Petitioner argues that under the Division's regulations, if the stock ownership and unitary business requirements are met and there are, in addition, substantial intercorporate transactions, the Division may presume that a combined report is necessary to avoid distortion and to properly reflect income. At this point, petitioner asserts, the burden is on the petitioner to rebut the presumption of distortion by showing that, despite the existence of substantial intercorporate transactions, the filing of a report on a separate basis does not result in a distortion of its activities, business, income or capital in New York State.

Petitioner asserts that it rebutted the presumption of distortion based on the Internal Revenue Service audit and the section 482 adjustments for the years at issue which, petitioner asserts, demonstrate that arm's-length pricing existed between petitioner and Labs. Petitioner asserts that this case is "on all fours with Digital," where the former State Tax Commission determined that the results of a Federal audit and adjustments demonstrated arm's-length pricing and that reporting on a combined basis was not necessary to properly reflect tax liability.

Petitioner asserts that the Division's position that an irrebuttable presumption exists when the regulatory criteria of ownership, unitary business and substantial intercorporate transactions are met is an improper interpretation of the statute and denies petitioner due process under the law.

Petitioner asserts that it and Labs are not unitary and that the Division has failed to show that they were unitary. Finally, petitioner asserts that forcing a combined report on petitioner would be a denial of its constitutional right to equal protection of the law.

The Division asserts that section 211(4) permits the Commissioner to require petitioner to file a combined report with Labs because the capital stock ownership and unitary business requirements of the statute and regulations had been met and the two had between them substantial intercorporate transactions, factors which, in effect, create an irrebuttable presumption that a combined report is necessary to avoid distortion and properly reflect income.

In the alternative, the Division asserts that, while its regulation relating to the required combination of non-taxpayers (20 NYCRR 6-2.5) does not contain a presumption of distortion (cf., 20 NYCRR 6-2.3 [concerning the required combination of taxpayers and the permissive combination of non-taxpayers]), such presumption is created where the stock ownership and unitary business requirements are met and there are, in addition, substantial intercorporate transactions. It is the Division's position that:

> "U.S.V. may overcome the presumption only by an affirmative showing that a separate filing accurately reflects its New York franchise tax liability. Matter of Digital Equipment Corporation, Decision of the State Tax Commission, June 28, 1985.
>
> "Once rebutted, or overcome, a presumption ceases to exist. (cite omitted) If evidence is presented which establishes that the franchise tax reports of related corporations filed on a separate basis accurately reflect franchise tax liability, there is no presumption of distortion, and combination is not required (nor will it be permitted). Matter of Digital Equipment, supra; see also, Matter of Boehringer Ingelheim Pharmaceuticals, Inc., Decision of the State Tax Commission, January 17, 1986" (Division's brief on exception, pp. 52-53).

The Division asserts that petitioner has not met its burden of proof.

The Division contends that it is not bound by the Closing Agreement and that, in any event, the section 482 adjustments made by the Internal Revenue Service in this case do not necessarily result in arm's-length pricing or justify the conclusion that, because such adjustments have been made, reporting on a separate basis results in a proper reflection of New York tax liability. Specifically, the Division asserts that:

> "[the] Closing Agreement represents a settlement reached [by petitioner] with the IRS. It is not a final federal adjustment of intercorporate transactions to reflect actual arm's-length transfer pricing. Rather it represents the parties agreement to adjust income and deductions between U.S.V. and Labs to correct for difficulties in valuing intangibles. Actual arm's-length transfer prices were not achieved -- at least by terms of the agreement which simply refers to 'Section 482 pricing adjustments' . . . The product of this 'mutual . . . agreement' was a quantification of the transfer price of goods sold U.S.V. by Labs in terms of a percentage attribution: 43.5% being attributed to U.S.V and 56.5% to Labs . . . . This is simply a <u>mechanical splitting of the profits</u> between two related entities.
>
> * * *
>
> "The agreement, by its terms, did not produce any consensus on arm's-length transfer pricing; rather it <u>appears</u> to be the parties 'best guess' concerning income/deduction attribution, after drawn out review" (Division's brief on exception referring to Division's brief at hearing, pp. 56-57, emphasis added).

The Division asserts that the Closing Agreement appears to have been made pursuant to the principles of section 936(h) of the Internal Revenue Code and that, while the agreement states that it is based upon the cost-sharing methodology, "the terms of the agreement, and the substance of the several adjustments more closely [reflect] the <u>profit-split</u> methodology" (Division's brief on exception, p. 65, emphasis added).

We deal first with the Division's interpretation of section 211(4).

In <u>Matter of Standard Mfg. Co.</u> (Tax Appeals Tribunal, February 6, 1992), we rejected the Division's interpretation of <u>Matter of Campbell Sales Co. v. New York State Tax Commn.</u> (68 NY2d 617, 505 NYS2d 54, <u>cert denied</u> 479 US 1088) that under section 211(4) substantial intercorporate transactions between a taxpayer and non-taxpayer, coupled with the unitary and stock ownership requirements of the statute and regulations, create an irrebuttable presumption that a combined report is necessary in order to avoid distortion and properly reflect income. We determined that the applicable standard was the proper reflection of income and that where the stock ownership, unitary business and substantial intercorporate transactions tests prescribed by the Division's regulations are met, a presumption of distortion arises which the taxpayer has the opportunity to rebut by showing that filing on a combined basis is not necessary to properly reflect income in order to succeed in its assertion that filing on a separate basis is appropriate. Nothing in the record here persuades us that our interpretation of section 211(4) in Standard should, in any way, be altered.

We deal next with petitioner's assertion that the Administrative Law Judge erred in concluding that USV and Labs were part of a unitary business.

As stated in Allied-Signal v. Division of Taxation (__ US __ [June 15, 1992]):

> "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 States' authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State."

While the indicia of a unitary business are functional integration, centralization of management and economies of scale (Container Corp. of Am. v. Franchise Tax Bd., 463 US 159, 179, reh denied 464 US 909), there is no single test for what a unitary business is; rather, there are a wide range of constitutionally acceptable variations on the unitary business theme (Container Corp. of Am. v. Franchise Tax Bd., supra, at 167).

The burden is on the taxpayer to show by clear and cogent evidence that the State tax results in extraterritorial values being taxed (Allied-Signal v. Division of Taxation, supra).

The crux of petitioner's argument is that the Audit Division relied entirely on the existence of substantial intercorporate transactions when making its determination, and that the Administrative Law Judge's conclusion of law on the issue of the unitary relationship merely states that:

> "[u]nder the regulations, petitioner and Labs were, in substance, parts of a unitary business. Labs was petitioner's sole supplier of Hygroton and Regroton and, with the exception of government sales, petitioner was Labs's [sic] sole distributor of such products (see, 20 NYCRR 6-2.2[b]; 20 NYCRR former 6-2.3[b])" (Determination, p. 31).

Petitioner asserts, in essence, that these factors do not comprise functional integration, centralization of management and economies of scale, the indicia of a unitary business. Petitioner asserts that evidence introduced by USV at hearing amply demonstrated that USV and Labs were not part of a unitary business since:

> "Labs conducted its own fully self-contained business entirely in Puerto Rico. It had its own personnel department and Director of Personnel, who trained its own employees locally, was responsible for recruiting and salary administration, and oversaw Labs' own benefit and educational assistance policies. Labs' employees had their own union, while USV's employees had no union at all. Labs had its own accounting departments, outside accountants and legal counsel. It was responsible for the procurement of its own raw materials, and did not benefit from any centralized purchasing facilities. Tr. 152-55. USV and Labs did not file, and were not required to file, a combined return in any other state, including California where USV filed its own return. Tr. 157" (Petitioner's brief on exception, pp. 54-55).

We reject petitioner's assertions. In our view, the Commissioner's regulations which are applicable to the periods at issue comport with the three indicia of a unitary business enunciated by the Supreme Court, i.e, functional integration, centralization of management and economies of scale. Specifically, the regulations provide that, 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:

> "(i) manufacturing or acquiring goods or property or performing services for other corporations in the group; or
>
> "(ii) selling goods acquired from other corporations in the group; or
>
> "(iii) financing sales of other corporations in the group.
>
> "(2) The Tax Commission, in deciding whether a corporation is part of a unitary business, will also consider whether the corporation is engaged in the same or related lines of business as the other corporations in the group, such as:
>
> "(i) manufacturing or selling similar products; or
>
> "(ii) performing similar services; or
>
> "(iii) performing services for the same customers" (20 NYCRR 6-2.2[b]).

New York courts reviewing cases which present issues of combination of taxpayers and foreign corporations have not specifically defined the term "unitary business." However, they have applied the regulations in light of the degree of integration of operation between the corporations.

In several cases, the courts have treated the unitary business test and the requirement of substantial intercompany transactions (20 NYCRR 6-2.3[c] [defining intercorporate transactions]) as facets of a single inquiry. In Matter of Campbell Sales Co. v. New York State Tax Commn. (supra), the court sustained the decision of the former State Tax Commission that filing on a combined basis was necessary on the bases of substantial intercorporate transactions and the fact that the taxpayer was the exclusive sales agent for its parent. Under facts similar to those in this case, Matter of Standard Mfg. Co. v. Tax Commn. (114 AD2d 138, 498 NYS2d 724, affd 69 NY2d 635, 511 NYS2d 229, appeal dismissed 481 US 1044), the court rejected the taxpayer's argument that it was not engaged in a unitary business, and affirmed the conclusion of the former State Tax Commission that Standard and its subsidiary (Caribbean) were engaged in a unitary business within the criteria of the Division's regulations.

The facts here are: Labs was created by petitioner in 1972 and is wholly owned by petitioner; in 1973, Labs manufactured Hygroton and Regroton, oral pharmaceuticals to treat hypertension, under a license agreement which granted Labs a royalty of 7 1/2% of petitioner's net sales of the products; in 1974, petitioner contributed the patents, trademarks and other rights it had acquired for these oral pharmaceuticals to Labs; by agreement entered into in 1974, petitioner provides management services and technical assistance to Labs in return for a fee of 2 1/2% of Labs' sales to petitioner; by agreement entered into in 1974, petitioner is the sole distributor in the United States and Puerto Rico for all products manufactured by Labs, with the exception of sales to the United States government; Labs sold approximately 95% to 97% of its products to petitioner; petitioner provided Labs with marketing forecasts, the apparent starting point for the calculation of Labs' production planning and material requirements; and all sales of Labs' products were handled by petitioner's sales and marketing staff. In our view, these facts support the conclusion reached by the Administrative Law Judge, i.e., that petitioner and Labs were engaged in the unitary business of the manufacture and sale of ethical pharmaceuticals.

We deal next with the pertinent inquiry of whether petitioner has met its burden of proof to show that its income would be properly reflected if it reported on a separate basis.

We reverse the determination of the Administrative Law Judge.

In Standard, we determined that the use of section 482 Federal adjustments to establish arm's-length pricing was appropriate to show that reporting on a separate basis would result in a proper reflection of income, particularly where the adjustments have been made for the same years at issue in the State audit.[27] We held further that the use of such adjustments for years other than those at issue in a State audit can be appropriate where it can be shown that the adjustments retain their economic validity. We held that while the "cost-plus" methodology used in the Federal audit may not be the preferred method to adjust intercorporate prices between related corporations, as asserted by the Division, it was in accordance with

[27]For the years at issue in this proceeding, section 482 provided:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses" (Internal Revenue Code of 1954 § 482, Pub.L. No. 83-591, § 482, 68A Stat. 162 [codified as amended at 26 U.S.C.A. § 482 (West Supp. 1988)]).

The regulations adopted by the Commissioner of Internal Revenue implementing section 482 deal with the transfer of tangible property (Treas Reg § 1.482-2[e][1]) and intangible property (Treas Reg § 1.482-2[d][1] and [2]) between commonly controlled entities. Both provide for adjustments to reflect the arm's-length price for the transaction.

"An arm's-length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's-length price normally involves profit to the seller" (Treas Reg § 1.482-2[e][1]).

The regulations describe and rank four methods for determining arm's-length prices: (1) the "comparable uncontrolled prices method," which looks at prices in sales between unrelated parties that involve identical or nearly identical products and conditions; (2) the "resale price method," which subtracts an appropriate markup from the price for which goods that the taxpayer purchases from an affiliate are resold to outside parties; (3) the "cost plus method," which begins with the transferor's production costs and adds an "appropriate gross profit percentage" to arrive at an arm's-length price to the transferee; and, in the event that none of these methods applies, arm's-length prices may be determined by (4) "some appropriate method of pricing other than the listed methods, or variations on such methods" (see, Treas Reg § 1.482-2[e][1][iii]).

Internal Revenue procedures. We concluded that the petitioner in <u>Standard</u> offered sufficient proof to show that its intercorporate transactions were at arm's length and that reporting on a separate basis resulted in a proper reflection of income.

In contrast, petitioner, here, has offered section 482 adjustments for the years at issue. The adjustments result from an extensive Federal audit and are contained in the Closing Agreement between petitioner and the Internal Revenue Service. The methodology used to arrive at the adjustments is set forth fully in Schedule B of the agreement.

First, the Division's argument that it is not "bound" by the Closing Agreement misses the point since petitioner offers the agreement not for the purpose of binding the Division, but as proof that the adjustments made pursuant to the agreement result in a proper reflection of income for New York purposes. In short, the issue is not whether the agreement is binding, but whether the adjustments result in a proper reflection of petitioner's income.

Second, we find no basis in the Division's assertions that the agreement did not reflect arm's-length pricing between petitioner and Labs.

Section 482 authorizes the adjustments by the Internal Revenue Service when it is determined such are necessary "clearly to reflect the

income . . ." of two or more corporations owned or controlled directly or indirectly by the same interests (Internal Revenue Code of 1954 § 482, Pub.L. No. 83-591, § 482, 68A Stat. 162 [codified as amended at 26 U.S.C.A. § 482 (West Supp. 1988)]). In the context of the Federal audit, the adjustments were made to insure that the income of petitioner for Federal purposes was clearly reflected. All aspects of the intercorporate relationship between petitioner and Labs were taken into account in formulating the adjustments, including: all third party sales by petitioner, less discounts, returns and allowances for the product; the cost of goods; advertising costs related to the product; allocation of petitioner's marketing costs (e.g., salaries of marketing personnel and other costs of the marketing department); allocation of petitioner's selling costs both direct (e.g., salesmen's expenses) and indirect (e.g., salaries of administrative staff);

allocation of distribution expenses of petitioner both direct (e.g., freight and postage) and periodic (e.g., salary of the distribution manager); allocation of general administrative expenses and R&D, as well as amortization of the patent to manufacture chlorthalidone, an ingredient of the product Hygroton/Regroton.

It seems clear that the Division conducted its audit on the premise that the substantial intercorporate transactions between petitioner and Labs, coupled with the criteria of stock ownership and unitary business, were sufficient to allow it to require a combined report (i.e., created the irrebuttable presumption). Accordingly, and as the record shows, the Division made no inquiries into the pricing structure between petitioner and Labs as part of its audit. As a result, the Division was not in a position to offer specific evidence as to why the methodology for the section 482 adjustments offered by petitioner do not result in a proper reflection of income. We find that the mere assertion by the Division that the adjustments do not reflect arm's-length pricing is not sufficient to show that petitioner has not met its burden to rebut the presumption of distortion.

In this context, we must also reject the determination of the Administrative Law Judge that the interdependent relationship of petitioner and Labs leads to the conclusion that "combination of the two is essential for portraying the true income of what was virtually one business" (Determination, p. 34). This conclusion merely states the facts which form the basis (1) for the use at the Federal level of section 482 adjustments to clearly reflect the income of two or more organizations which are owned or controlled directly or indirectly by the same interests and (2) for the presumption of distortion which arises under section 211(4) and the Commissioner's regulations which may be rebutted by petitioner. It provides no rationale for the rejection of the section 482 adjustments offered by petitioner, nor does it show why those adjustments do not meet petitioner's burden of proof to rebut the presumption of distortion. Along these lines, we also reject the conclusion of the Administrative Law Judge that even if the section 482 adjustments resulted in arm's-length pricing "it does not necessarily follow that there would have been no distortion of income [because] the basic aim of Internal Revenue Code

§ 482 is to . . . determine if the prices and terms of [intercorporate] transactions are truly arm's length . . . [while the purpose of section 211(4)] is broader, and envisions more than an examination of intercorporate pricing, requiring examination of the entire intercorporate relationship" (Determination, pp. 34-35).

We reject this conclusion because we find nothing in the distinctions pointed out by the Administrative Law Judge to support his thesis that arm's-length pricing achieved pursuant to the section 482 adjustments does not achieve a proper reflection of income for State purposes.

The fact of the matter is that both section 482 and section 211(4) share a common purpose, the proper reflection of income. New York State proceeds on the basic premise that every corporation is a separate entity which must file its own report (20 NYCRR 6-2.1) and the State utilizes the concept of a rebuttable presumption of distortion to provide the opportunity for taxpayers to show that such corporate entities operate as separate entities and that reporting on a separate basis results in a proper reflection of income. The regulations promulgated under section 482 proceed on the theory of treating:

> "each of the individual members of a commonly controlled group as a separate entity, transactions between which are taxable events to be conformed to the economic realities that would obtain between independent economic entities conducting the identical transactions at arm's length (citations omitted). This contrasts with the alternative theoretical model, the unitary entity theory, which considers all commonly controlled entities as 'parts of the same unitary business,' with the result that 'intercompany transactions cannot produce a real economic profit or loss and must therefore be eliminated from tax consideration'" (<u>Bausch & Lomb v. Commissioner</u>, 933 F2d 1084, 91-1 USTC ¶ 50,244).

Finally, we reject the Division's assertion that the Closing Agreement is not determinative because "it appears on its face to have been made pursuant to at least the principles of section 936(h)" (Division's brief on exception, p. 64). Section 936(h) was enacted in 1982 and does not apply to the years at issue herein. The Closing Agreement was executed in 1984 and indicates that:

> "[t]he method for deriving the Section 482 pricing adjustment is a cost sharing arrangement of the <u>type</u> applicable under Section 936(h) for post-

> TEFRA years and is derived by taking into account U.S. and Puerto Rico activities" (Closing Agreement, Exhibit "K," p. 4 of 6, emphasis added).[28]

Further, it would appear that even if the adjustments utilized the profit-split method, the result would not be different since that is one of the same methods used, when appropriate, under section 482 (Eli Lilly & Co. & Subsidiaries v. Commissioner, 84 TC 996, affd in part, revd in part, 856 F2d 855, 88-2 USTC ¶ 9502).[29]

In view of the above conclusion, we do not deem it necessary to deal with the constitutional issues raised by petitioner concerning the application of New York law to it.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of USV Pharmaceutical Corporation is granted;
2. The determination of the Administrative Law Judge is reversed;
3. The petition of USV Pharmaceutical Corporation is granted; and

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[28] For tax years after 1982, a taxpayer electing the tax credit under Internal Revenue Code § 936 (Puerto Rico and Possession Tax Credit) must compute its income derived from the active conduct of a trade or business in a possession by electing one of two methods, cost/sharing (§ 936[h][5][C][i]) or profit/split (§ 936[h][5][C][ii]). If cost/sharing is elected, "the electing corporation (must) determine its intercompany pricing under the appropriate section 482 method" (§ 936[h][5][C][i][IV][b]). If the profit/split methodology is elected, there is no specific reference to section 482 for purposes of determining intercompany pricing (§ 936[h][5][C][ii]).

[29] In Lilly, the "Tax Court evaluated . . . transfer prices [for the years 1971-1973] in accordance with the published standards for assessing whether transactions conform to arm's-length practices" (Eli Lilly & Co. & Subsidiaries v. Commissioner, 856 F2d 855, 868). For the years 1971-1972, the Tax Court determined that none of the specifically enumerated approaches to determining arm's-length prices applied and also rejected Lilly's variant on the resale price method, the so-called "opportunity cost approach." The Tax Court applied the "profit/split" methodology which divides combined revenues based on an ad hoc assessment of the contributions of the assets and activities of the commonly controlled enterprises. The Court of Appeals sustained the use of this approach by the Tax Court as another "appropriate method" under section 482 to determine arm's-length pricing.

4. The Division of Taxation is directed to cancel the notices of deficiency dated December 16, 1983.

DATED: Troy, New York
July 16, 1992

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

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

/s/Maria T. Jones
Maria T. Jones
Commissioner