STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
STANDARD MANUFACTURING CO., INC.	:	DECISION DTA No. 801415
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 July 31, 1980 and July 31, 1981.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on June 21, 1990 with respect to the petition of Standard Manufacturing Co., Inc., 750 Second Avenue, North Troy, New York 12182 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 July 31, 1980 and July 31, 1981. Petitioner appeared by Lombardi, Reinhard, Walsh & Harrison, P.C. (Thomas J. Jordan, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

An amicus curiae brief was filed by Morrison and Foerster (Arthur R. Rosen, Esq. of counsel).

Both parties filed briefs on exception. Oral argument, at the request of the Division of Taxation, was heard on June 27, 1991.

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

ISSUE

Whether the Division of Taxation may properly require petitioner, Standard Manufacturing Co., Inc., and its subsidiary, Caribbean Outerwear Corporation, to file combined franchise tax reports for the fiscal years ended July 31, 1980 and July 31, 1981.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "1" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

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

> On March 4, 1983 and June 10, 1983, the Division of Taxation issued separate statements of audit adjustment against petitioner, Standard Manufacturing Co., Inc. (hereinafter "Standard Manufacturing") for the fiscal years ended July 31, 1980 and July 31, 1981 (hereinafter "1980" and "1981") showing corporation franchise tax deficiencies of $79,169.96 plus interest and $37,537.65 plus interest, respectively. Each statement contained the same explanation:
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> > "This estimated deficiency is for failure to file a New York State franchise tax report, Form CT-3 for Caribbean Outerwear Corp. and to include such income on the combined report of Standard Manufacturing Co. as required by our letters of September 21, 1978 and July 26, 1980."
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> > The September 21, 1978 letter provided, in relevant part, as follows:
> >
> > "Section 211.4 of the New York State Tax Law states that a combined report may be required if 'the Tax Commission deems such a report necessary, because of intercompany transactions or some agreement, understanding, arrangement or transaction referred to in subdivision 5 of this section, in order properly to reflect the tax liability under this article.'
> >
> > "Although there is no agreement or arrangement between Carribbean [sic] Outerwear Corp. and Standard Manufacturing Co. Inc., there are substantial intercorporate transactions which would make a combined report necessary to properly reflect the tax.
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> > "Therefore, the inclusion of Carribbean [sic] Outerwear Corporation in the combined group is proper."[1]

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[1]We modified finding of fact "1" of the Administrative Law Judge's determination to add the relevant text of the Division's September 21, 1978 letter to petitioner.

On July 7, 1983 and August 18, 1983, the Division of Taxation issued separate notices of deficiency against Standard Manufacturing for 1980 and 1981 showing corporation franchise tax deficiencies of $79,169.96 plus interest and $37,537.65 plus interest, respectively.

Standard Manufacturing, a New York corporation, began business as a corporation in January 1961 although its predecessor had been in business since 1924. The company manufactures, buys and sells outerwear, in particular, jackets, windbreakers and so-called "tennis wear".

A review of petitioner's New York corporation franchise tax reports for each of the years at issue discloses that none of its three corporate officers, George Arakelian, President, John Arakelian, Vice-President nor Dorothy King, Secretary-Treasurer, received any salary and/or any other compensation from petitioner. Petitioner also reported negative "entire net income" for 1980 and 1981 of ($435,056.08) and ($538,071.80), respectively. Nonetheless, "end of year" total assets were reported for 1980 and 1981 of $15,359,844.54 and $14,261,985.82,[2] respectively, and the average fair market value of current liabilities for 1980 and 1981 were reported as $7,628,978.39 and $7,268,844.66, respectively.

In contrast to the lack of compensation shown paid to petitioner's officers on the New York reports, the respective schedules E of the forms 1120, U.S. corporation income tax returns for petitioner and its subsidiaries[3] that were attached to the New York reports, show compensation of officers as follows:

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[2]Petitioner incorrectly reported end of year assets of $8,371,261.36 on the first page of the report for 1981. It appears an error was made in transposing the correct figure from line 46 of Schedule E inside the report.

[3]Petitioner filed combined New York corporation franchise tax reports for each of the years at issue with only two of its subsidiaries, Standard Leasing of Troy, N.Y., Inc. and 750 Second Ave. Management Corp. At places in the reports, 750 Second Ave. Management Corp. is described as 750 Second Ave. Realty Corp. There is no explanation in the record for this variance. Petitioner also included an additional subsidiary, Logan Manufacturing Co., Inc., in its federal corporation income tax returns. Logan is an apparel manufacturer located in Logan, West Virginia.

	1980	1981
George Arakelian	144,184.03	131,628.72
John Arakelian	61,176.41	None
Dorothy King	141,820.17	88,003.94

Schedules attached to each of the Federal returns show that compensation of officers of $347,180.61 and $219,632.66 for 1980 and 1981, respectively, was paid by petitioner's subsidiary, 750 Second Ave. Management Corp.

The Federal returns show negative Federal "taxable income" of ($846,824.28) and ($634,911.01) for 1980 and 1981, respectively. Further, petitioner's Federal returns show percentages of corporation stock owned as follows

	Common	Preferred
George Arakelian	50%	
John Arakelian		100%
Dorothy King	50%	

George Arakelian, who has been president of Standard Manufacturing since 1965, testified that petitioner established Caribbean Outerwear Corporation (hereinafter "Caribbean") in 1968:

> "We needed to expand our business and that was one of the areas that we wanted to go and set up a manufacturing facility. We needed more production."

Caribbean (a Delaware corporation) is a wholly-owned subsidiary of Standard Manufacturing located in Yabucoa, Puerto Rico. In addition to the significant tax incentives for locating a company in Puerto Rico, there is a substantial labor savings incentive. Standard Manufacturing and Caribbean manufacture similar products, which entails the employment of approximately 150 and 200 sewing machine operators, respectively. On average, it appears that Standard Manufacturing's sewing machine operators are compensated at a rate approximately 35% more per hour than Caribbean's.

Petitioner conceded that it purchased, during each of the years at issue, more than 50 percent of the total product manufactured by Caribbean and that both corporations had the same persons on their respective boards of directors. As noted on Caribbean's Federal corporation income tax returns, George Arakelian, John Arakelian and Dorothy King served as Caribbean's

officers as well, but no compensation was shown on Caribbean's tax returns. In fact, petitioner, by its representative, stipulated that "there are substantial intercorporate transactions" between Standard Manufacturing and Caribbean and admitted that the two corporations were part of a unitary business.

Nonetheless, George Arakelian testified that Caribbean was run as an independent business from Standard Manufacturing with separate managers and employees; that Standard Manufacturing provided no technical assistance or training to Caribbean; that there was no exchange of personnel or internal transfer of materials between the two companies; and that there was no financing of Caribbean's operation by Standard.

A review of the forms 1120, U.S. corporation income tax returns, of Caribbean for the years at issue show a financially successful operation:

	Fiscal Year Ending July 1, 1980	Fiscal Year Ending July 1, 1981
Gross receipts or sales	$6,087,991.66	$4,739,062.50
Total income	$1,548,836.32	$1,171,392.23
Taxable income	$1,297,105.24	$ 963,409.46
Total tax	None	None

The Internal Revenue Service audited the corporation tax returns of petitioner and Caribbean for the 1976 and 1977 fiscal years. Petitioner introduced into evidence a Form 4549-A, Income Tax Examination Changes (hereinafter, "revenue agent's report"), for these earlier years that shows an adjustment under Internal Revenue Code § 482 of the price of goods sold by Caribbean to Standard in order to reflect an arm's length price. The Office of International Operations of the Internal Revenue Service participated in this adjustment of the pricing of intercompany sales. The revenue agent's report notes:

> "Pricing of goods from Puerto Rican subsidiary to U.S. parent was adjusted to reflect an arm-length price under Code

section 482, Rev. Proc. 63-10 and Mis 42G 166.[4] The results of this pricing adjustment for the years under audit are as follows:

7/31/73	$283,083
7/31/76	$ 22,481
7/31/77	$ 30,876"

Donald Shutt, a certified public accountant, who has been Standard Manufacturing's independent accountant for approximately 25 years testified that the adjustment to the pricing of sales by Caribbean to petitioner made by the IRS for the earlier years was a formula:

> "And the formula was to be a self-adjusting formula so that it could be used consistently over the subsequent years. So that each year the IRS wouldn't have to come in and audit the corporate records in order to establish a new price, new intercompany selling price."

The formula was cost of goods sold plus a 10 percent markup plus a labor savings factor of 35 percent. The specific calculation for the two earlier years under Federal audit was as follows:

	Fiscal Year Ending 7/31/76		Fiscal Year Ending 7/31/77	
Cost of Goods Sold	$2,956,047.00		$4,093,229.00	
Less Non-Productive Salaries	12,287.00		15,850.00	
Adjusted Cost of Goods Sold	$2,943,760.00		$4,077,379.00	
10% Mark-up		294,376.00		407,738.00
Labor Savings @35%		418,414.00		626,295.00
Total	712,790.00		1,034,033.00	
Intercompany transfer price	3,656,550.00		5,111,412.00	
Intercompany transfer price per return	3,679,031.00		5,142,288.00	
Sec. 482 Adjustment (Pricing)	$ 22,481.00		$ 30,876.00	

Donald Shutt testified that in preparing the tax returns for petitioner and Caribbean for the years at issue, and, in fact, all years subsequent to the IRS audit, he determined the intercompany transfer price by utilizing this so-called "cost plus" formula described above. He also testified that an analysis of (1) Caribbean's gross profit percentages and percentages of labor cost to cost of

[4]It is unclear what this abbreviation refers to.

goods sold and (2) petitioner's gross profit percentages and percentages of labor to cost of goods sold show that the formula retained its economic validity. In particular, he gave his opinion that the labor savings adjustment of 35%[5] and the 10% mark-up remained a fair method to determine the pricing of products sold by Caribbean to petitioner. Mr. Shutt also opined that if petitioner is required to file a combined return with Caribbean, there would be a distortion of income in favor of New York:

> "(T)here are three factors in the apportionment rule, and those factors are sales, labor, and property and equipment....
> ...(L)abor is cheaper in Puerto Rico than in New York State. So, therefore, by using the labor factor, it distorts in New York State's favor the percentage of income earned in New York State.
> Also, Puerto Rico has a distortion in regard to property and equipment because the Puerto Rican government provided the company with a factory building.
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> * * *
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> The factory building was provided by the Puerto Rican government at a relatively low rental value, which again distorts New York State's apportionment of income to New York State. So, therefore, I don't believe that combining these two corporations truly reflects New York State's taxable portion of income earned."

In addition to the adjustment of the pricing of goods sold by Caribbean to Standard Manufacturing, a review of the revenue agent's report also discloses that an adjustment was made by the Internal Revenue Service under IRC § 482 to set up a charge to the Puerto Rican subsidiary (Caribbean) for services performed on its behalf by Standard Manufacturing. These

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[5]Earlier in the hearing, George Arakelian testified on direct examination that based upon his weekly review of the payroll records of petitioner and Caribbean, the difference of the labor costs and wage rates paid by petitioner as opposed to the same costs which are paid by Caribbean is 35%. It should be noted that this testimony was brought out by questions that could be described as leading. On cross-examination, Mr. Arakelian noted that "the cost of manufacturing, the direct labor that goes into the manufacture of the product is thirty-five percent less at Puerto Rico than it is at Troy." He later conceded that the 35% is not an exact figure, but an average one for 1980 and 1981, as well as for earlier and subsequent years. Although Mr. Arakelian's testimony with regard to the difference in labor costs of petitioner and Caribbean seemed, to some extent, crafted, it does reinforce the testimony of Mr. Shutt.

services included managerial, accounting, financial and other services. The report provided the following detailed calculation to show how charges to Caribbean of $125,464.00 for the fiscal year ended July 31, 1976 and $135,302.00 for the fiscal year ended July 31, 1977 for such services from petitioner were determined:

	Fiscal Year Ended 7/31/76	
Sales	Standard Manufacturing	$ 7,638,130.3_[6]
	Logan Mfg. Co., Inc.	1,600,__9.61
	Caribbean	3,679,030.72
Total Sales		12,917,771.15
	Caribbean % of Sales	$\frac{3,679,030.72}{12,917,771.15} = 28.48\%$
	Expenses to be allocated	430,000[7]
	Applicable Percentage	28.48%
	Management Fee Allocation	122,464
	Charge for Computer and Delivery of Payroll	3,000
	Total Management Fee	$ 125,464.00
	Fiscal Year Ended 7/31/77	
Sales	Standard Manufacturing	$10,113,639.00
	Logan Mfg. Co., Inc.	2,507,339.00
	Caribbean	5,142,268.00
Total Sales		17,763,246.00
	Caribbean % of Sales	$\frac{5,142,268}{17,763,246} = 28.95\%$

[6]It is difficult to determine from the poor copy of the revenue agent's report in the record some of the digits on these calculations of the adjustment for management services, and the unreadable digits have been left blank.

[7]The expenses to be allocated in both calculations, as noted in the revenue agent's report, consisted of the "total expenses of 730 Second Ave. Management Corp. which is allocated among all the manufacturing members of the controlled group."

Expenses to be allocated	$ 457,000
Applicable percentage	28.95%
Management Fee	132,302
Change for Computer and Delivery of Payroll	3,000
Total Management Fee	$ 135,302.00

Petitioner at the hearing herein did not focus upon or address the adjustments made by the Internal Revenue Service for management fees, which in effect, decreased Caribbean's income and increased petitioner's income for the periods ended July 31, 1976 and July 31, 1977. There was no evidence introduced concerning whether similar adjustments would need to be made by petitioner for subsequent years other than the general testimony of George Arakelian that petitioner and Caribbean had separate managers and that petitioner provided no technical assistance or training to Caribbean, as noted above.

The Division of Taxation and petitioner have agreed that if it is determined that Standard Manufacturing is required to file a combined franchise tax report including Caribbean, the tax due shall be determined by a business allocation percentage (Tax Law § 210.3), and that the tax deficiencies shall be revised as follows:

Fiscal Year Ended	Deficiency
July 31, 1980	$24,125.77
July 31, 1981	$ 9,860.54

OPINION

The Administrative Law Judge determined that: the Division of Taxation's (hereinafter the "Division") current regulations were applicable to the periods at issue; petitioner and Caribbean met the capital stock and unitary business requirements of the regulations and engaged in substantial intercorporate transactions which gave rise to a rebuttable presumption that filing on a separate basis would distort the income of petitioner in New York State; the ultimate test as to whether the Division could require petitioner to file on a combined basis with Caribbean was whether under all of the circumstances of the intercompany relationship, combined reporting fulfilled the statutory purpose of avoiding distortion and of more realistically portraying true

income; the burden of proof to rebut the presumption was on petitioner; and that petitioner introduced sufficient evidence to rebut the presumption that its income would be distorted if it reported on a separate basis.

Specifically, the Administrative Law Judge determined that: the cost-plus formula utilized by the Internal Revenue Service to adjust the pricing of goods purchased by petitioner from Caribbean for the 1976 and 1977 tax years was reasonable and in accord with the Internal Revenue Service procedures; the credible testimony of petitioner's accountant established that petitioner applied the same cost-plus formula in calculating the pricing of goods purchased by petitioner from Caribbean during the years at issue; and that application of that formula resulted in arms-length pricing of the sales between petitioner and Caribbean. Thus, the Administrative Law Judge concluded that petitioner had overcome the presumption of distortion resulting from the intercorporate transactions and unitary business relationship of petitioner and Caribbean.

Finally, the Administrative Law Judge determined that petitioner failed to address the adjustment made by the Internal Revenue Service which decreased Caribbean's income and increased petitioner's income for 1976 and 1977 to account for management services that had not been previously charged to Caribbean for management fees charged by petitioner. The Administrative Law Judge directed the Division to determine an allocation for New York State purposes utilizing the methodology utilized by the Internal Revenue Service.

The Division asserts that section 211(4) permits the Commission to require a taxpayer to file a combined report with a nontaxpayer whenever there are intercorporate transactions between them. Relying on Matter of Wurlitzer Co. v. State Tax Commn. (35 NY2d 100, 358 NYS2d 762) and Matter of Campbell Sales Co. v. New York State Tax Commn. (68 NY2d 617, 505 NYS2d 54, reh denied 68 NY2d 808, 506 NYS2d 1038), the Division asserts that the phrase "in order properly to reflect the tax liability" only refers to combination resulting from section 211(5) agreements. Accordingly, the Division asserts that it was reasonable to require petitioner to file its franchise tax report on a combined basis with Caribbean, as petitioner and Caribbean were

engaged in a unitary business and had between them substantial intercorporate transactions, factors which, in effect, created an irrebutable presumption that a combined report was necessary (Division's Notice of Exception, Proposed Conclusion of Law "C").

In the alternative, the Division asserts that while its regulation, which applies to the required combination of non-taxpayers (20 NYCRR 6-2.5), does not contain a distortion requirement (compare, 20 NYCRR 6-2.3 concerning required combination of taxpayers and permissive combination of non-taxpayers), the statute and case law establish that when the Division requires a taxpayer to file on a combined basis with a non-taxpayer, such filing must be necessary "to properly reflect tax liability." The Division states that the ultimate question is whether, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion and more realistically portraying true income (Division's Notice of Exception, Proposed Conclusion of Law "D"). The Division asserts that petitioner has failed to meet its burden of proof that filing on a separate basis results in a proper reflection of petitioner's tax liability in New York State.

Petitioner asserts that the Administrative Law Judge's determination is correct in all respects and that there is a presumption of distortion which it has successfully rebutted.

We affirm the determination of the Administrative Law Judge.

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

Tax Law § 211(4) provides that:

> "In the discretion of the Commissioner of Taxation and Finance, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations . . . may be required or permitted to make a report on a combined basis covering any such other corporations . . . provided, further, that no combined report covering any corporation not a taxpayer shall be required unless the commissioner deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article . . ." (Tax Law § 211[4], emphasis added).

Section 211(5) provides, in relevant part that:

> "[i]n case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income, deductions and capital, and to eliminate assets in computing any allocation percentage provided only that any income directly traceable thereto be also excluded from entire net income, so as equitably to determine the tax" (Tax Law § 211[5], emphasis added).

The Commissioner's regulations provide that the Commissioner may permit or require taxpayers and permit non-taxpayers to be included in a combined report if the stock ownership, unitary business, and distortion tests are met.[8] The regulations provide that the Commissioner can

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[8]The Commissioner's regulations at 20 NYCRR 6-2.3(a), effective for all taxable years beginning on or after December 31, 1983, provide that:

> "If the capital stock and unitary business requirements . . . have been met, the [Commissioner] may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the . . . income . . . in New York State of the taxpayers. The . . . income . . . of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations" (20 NYCRR 6-2.3[a], emphasis added).

In addition, the Commissioner:

> "may permit a corporation which is not a taxpayer to be included in a combined report if reporting on a separate basis distorts the . . . income . . . of one or more taxpayers. The . . . income . . . of a taxpayer will be presumed to be distorted . . . if there are substantial intercorporate transactions among the corporations" (20 NYCRR 6-2.3[b], emphasis added).

The regulations provide further:

> "In determining whether there are substantial intercorporate transactions, the Tax Commission will consider transactions directly connected with the business conducted by the taxpayer, such as:
>
> > "(1) manufacturing or acquiring goods or property or performing services for other corporations in the group;
> >
> > "(2) selling goods acquired from other corporations in the group;

(continued...)

require a non-taxpayer to be included in a combined report in order to properly reflect the tax liability of one or more of the taxpayers in the group.[9]

In Matter of Autotote Ltd. (Tax Appeals Tribunal, April 12, 1990), this Tribunal held that a taxpayer corporation seeking combination with a non-taxpayer corporation could file a combined report because separate reports would result in distortion. We stated that combined reports are permitted where:

> "the parent owns or controls substantially all of the stock of the subsidiary; the corporations are, in substance, part of a unitary business conducted by the entire group of corporations; and if, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income (Matter of Campbell Sales Co. v. State Tax Commn., 68 NY2d 617, 505 NYS2d 54, 54-55; see also, Matter of Wurtlitzer Co. v. State Tax Commn., 35 NY2d 100, 358 NYS2d 762; Matter of Coleco Industries v. State Tax Commn., 92 AD2d 1008, 461 NYS2d 462; 20 NYCRR 6-2.5[a])" (Matter of Autotote Ltd., Tax Appeals Tribunal, April 12, 1990).

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[8](...continued)

> "(3) financing sales of other corporations in the group; or
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> "(4) performing related customer services using common facilities and employees" (20 NYCRR 6-2.3[c]).

This provision is substantially the same as the 1976 regulation covering intercorporate transactions.

[9]The regulations provide that a foreign corporation not subject to tax:

> "will not be required to be included in a combined report unless the requirements described in section 6-2.2 of this Part have been met and the [Commissioner] determines that inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:
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> "(1) substantial intercorporate transactions . . ." (20 NYCRR 6-2.5, emphasis added).

The Division now asserts that the question of income distortion is not applicable where the Division seeks to require combination between a non-taxpayer and a taxpayer corporation on the basis of substantial intercorporate transactions between the two

The Division relies on the following language in Campbell for its position:

> "as we made clear [in Wurlitzer] 'it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected' before the Commission may exercise [its] discretion [under § 211(4)] and require combined reports because of intercompany transactions" (Matter of Campbell Sales Co. v. State Tax Commn., supra, 505 NYS2d 54, 55).

We cannot agree. The Division now attributes a meaning to section 211(4) which the Tax Commission in Wurlitzer never sought to attribute to it and which the Division's own regulations do not and never have attributed to it. In our view, Campbell, Wurlitzer and the Division's regulations support the conclusion that the existence of intercorporate transactions is sufficient to allow the Division to require filing on a combined basis; that the Division does not, as a "condition precedent" to such requirement, have to show that such transactions were unfair; but that the taxpayer does have the opportunity to show that filing on a combined basis is not necessary to properly reflect tax liability.

The root of the current controversy lies in the fact that in Wurlitzer the taxpayer argued:

> "that the Tax Commission could not require a combined report because the Tax Law (section 211, subds. 4 and 5) requires a showing of unfair transactions between the taxpayer (Wurlitzer) and its subsidiary corporation (WAC) as a prerequisite to a combined report" (Matter of Wurlitzer Co. v. State Tax Commn., 42 AD2d 247, 346 NYS2d 471, 473-474, emphasis added).

In response, the Commission argued:

> "that the inclusion of a non-taxpayer (WAC) in a combined report with a taxpayer (Wurlitzer), in order to reflect the proper tax liability, is permissible in two separate situations: (1) because of intercompany transactions or (2) because of an agreement, understanding or arrangement whereby the taxpayers' income or capital is improperly or inaccurately reflected. It is the Commission's position that it need not show that the intercompany transactions were unfair as between the two corporations, but rather, that such transactions result in an inaccurate reflection of the

> entire net income of the taxpayer" (Matter of Wurlitzer Co. v. State Tax Commn., supra, 346 NYS2d 471, 474, emphasis added).

The Appellate Division affirmed the Tax Commission (Matter of Wurlitzer Co. v. State Tax Commn., supra, 346 NYS2d 471, 474-475) finding:

> "that the purpose of subdivisions 4 and 5 of section 211 is to prevent the distortion of the net income of a taxpayer. Such distortion, so as to inaccurately reflect the taxpayer's entire net income, can occur either through intercompany transactions or an unfair agreement. There is nothing in the statute or its legislative history which mandates a showing that intercompany transactions were unfair as a prerequisite to requiring a combined report. The instant case is proof of this proposition" (Matter of Wurlitzer Co. v. State Tax Commn., supra, 346 NYS2d 471, 475, emphasis added).

The Court of Appeals affirmed, holding that:

> "[t]he use in subdivision 4 of the word 'or' with reference to subdivision 5, under which the Commission, where it appears that a taxpayer's income within the State is improperly or inaccurately reflected, may, in its discretion, require combined reports or may include fair profits in entire net income, makes it clear that when the Commission acts pursuant to the power conferred by subdivision 4, it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected. The statute envisions and covers separate situations.
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> * * *
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> "On this record, the Commission could properly conclude that separate reports would not accurately reflect the taxable income or the taxable liability. Neither in the statute nor the regulations promulgated under it, is there any requirement of 'unfairness' in transactions between the affiliated corporations . . . . Requiring a combined report is an accurate reflection of the income which is subject to taxation" (Matter of Wurlitzer Co. v. State Tax Commn., 35 NY2d 100, 358 NYS2d 762, 766, emphasis added).

The Court of Appeals, while it may have used different language, i.e., "condition precedent" versus "prerequisite," reached the same result as the Appellate Division, i.e., that a combined report could be required where necessary to accurately reflect the income which is subject to taxation, and that it is not a condition precedent (or a prerequisite) that the Commissioner show that the intercorporate transactions were unfair as Wurlitzer had argued.

In 1986, the court in Campbell merely reaffirmed its decision in Wurlitzer, stating that:

> "as we made clear [in Wurlitzer] 'it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected' before the Commission may exercise that discretion and require combined reports because of intercompany transactions . . . In any event, the State Tax Commission here expressly found that 'a proper reflection of *** New York franchise tax liability is impossible without combination.' This conclusion is plainly rational (see, 20 NYCRR 6-2.3[c]). Petitioner and its related corporations have substantial intercompany transactions, which demonstrate that they have a symbiotic relationship to each other and that petitioner is a vital link in the over-all enterprise. Moreover, since its inception, petitioner has exclusively solicited sales for Campbell's Soup in 34 States" (Matter of Campbell Sales Co. v. State Tax Commn., supra, 505 NYS2d 54, 55).

We find nothing in these opinions which indicates that the exercise of the Commissioner's discretion to require inclusion of a non-taxpayer in a combined report is not to be based on the rationale that such combination is necessary to properly reflect franchise tax liability. Neither do we find support for the conclusion that the existence of a unitary business relationship and substantial intercorporate transactions between a taxpayer and non-taxpayer corporation creates, in effect, an irrebuttable presumption that a combined report is necessary in order properly to reflect tax liability. If that were the case, it would not have been necessary for the court in either case to make any statements that the requirement of combination was necessary to accurately reflect income. We also note that the Division's interpretation discounts entirely the post-Campbell decision in Matter of Standard Mfg., where the court stated that:

> "the ultimate question is whether under all of the circumstances of the intercompany relationship . . . combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income. In answering this question, no single factor is decisive (Matter of Coleco Inds. v. State Tax Comm., supra, 92 AD2d 1009, 461 NYS2d 462)" (Matter of Standard Mfg. Co. v. Tax Commn. of State of New York, 114 AD2d 138, 498 NYS2d 724, 726, affd 69 NY2d 635, 511 NYS2d 229).[10]

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[10]In Standard, the Court of Appeals affirmed "for the reasons stated in the opinion of Justice Robert G. Main at the Appellate Division" and referred to its opinions in Wurlitzer and Campbell. In our view, the Court's affirmance in Standard reflects its approval of the result reached by the Appellate Division and the reasoning of the

(continued...)

Finally, we point out that the Division's assertion is one which is inconsistent with its own regulations, both past and present. These regulations have consistently taken a more restrictive approach to the exercise of the Division's discretionary authority than that now espoused by the Division by providing that mandatory combination of non-taxpayers with taxpayers be based not only on unity of ownership and intercorporate transactions, but also on the requirement that a combined report is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of substantial intercorporate transactions or section 211(5) type agreements (20 NYCRR 6-2.5, effective for tax years beginning on or after December 31, 1983; former 20 NYCRR 6-2.5 effective for tax years beginning on or after January 1, 1976; former §§ 5.28[b] and 5.28[c], Ruling of the State Tax Commission issued March 14, 1962).

If, as urged by the Division, the fact of substantial intercorporate transactions is in itself sufficient to require combination, then the phrase in its regulations "in order to properly reflect tax liability" is rendered meaningless. Alternatively, if the phrase creates a standard to guide the Division's actions, then, under the Division's interpretation, the Division's compliance with the standard can never be challenged. We find either conclusion insupportable.

These regulations have not been invalidated by court decisions nor have they been amended by the Division to embrace the new policy it now espouses. Clearly, the Division is bound by its own regulations (Matter of Frick v. Bahou, 56 NY2d 777, 452 NYS2d 18). In this regard, we point out that the former State Tax Commission in Matter of Digital Equip. Corp. (State Tax Commn., October 14, 1985) and Matter of Boehringer Ingelheim Pharm. (State Tax Commn., April 30, 1986) took the position that the existence of intercorporate transactions

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[10](...continued)
Appellate Division in reaching that result and should be accorded no less weight than its "full opinions" in Wurlitzer and Campbell.

between a taxpayer and non-taxpayer did not lead to the result that filing on a combined basis was necessary to properly reflect tax liability.

For all of the above reasons, we conclude that the issue of whether the Division properly required petitioner and its subsidiary to file a combined report is not resolved simply by the finding that there were substantial intercorporate transactions between the two. Instead, our inquiry must continue to determine whether petitioner has introduced sufficient evidence to show that its income would be properly reflected if it reported on a separate basis from Caribbean.

The Division differentiates this case from Matter of Digital Equip. Corp. (supra) asserting that petitioner's "apparent" adoption of the Internal Revenue Service methodology for computing transfer pricing does not establish that the prices charged by Caribbean for the period in issue were, in fact, arms-length prices and that without documentary evidence (e.g., a closing agreement with the Internal Revenue Service for the periods at issue), it cannot be established with any certainty that the transfer prices reflected on the returns for the periods in issue represent prices which the Internal Revenue Service would accept as "arms-length" (Division's Notice of Exception, Proposed Conclusion of Law "G"). The Division asserts that the cost-plus methodology is the least preferred method for determining arm's-length pricing between related corporations and may not have been truly appropriate in this case (Division's brief on exception, pp. 36-46).

We affirm the determination of the Administrative Law Judge.

First, we find the use of Federal adjustments to establish arm's-length pricing appropriate, particularly where the adjustments have been made for the same years at issue in a state proceeding (see, e.g., Matter of Digital Equip. Corp., supra). Second, we find that use of such adjustments for years other than those at issue in the State proceeding can be appropriate where it can be shown that the adjustments retain their economic validity (see, e.g., Matter of Boehringer Ingelheim Pharm., supra). Here, cost-plus may not be the preferred method, as the Division asserts (see, Rev Proc 63-10 [1963-1 CB 490]). However, we find nothing to cause us to alter

the determination of the Administrative Law Judge that the cost-plus formula utilized by the Internal Revenue Service to adjust the pricing of goods purchased by petitioner from Caribbean during the 1976 and 1977 tax years was reasonable and in accord with the Internal Revenue Service procedures. Petitioner introduced into evidence the revenue agent's report (Petitioner's Exhibit "5," Form 4549-A, Income Tax Examination Changes) for the 1976 and 1977 tax years which shows an adjustment under Internal Revenue Code § 482 of the price of goods sold by Caribbean to petitioner in order to reflect an arm's-length price.

Moreover, as the Administrative Law Judge determined, the credible testimony of Mr. Shutt, a certified public accountant who had been petitioner's independent accountant for 25 years, established that petitioner applied the cost-plus formula in calculating the pricing of goods for the years at issue.

Finally, the Division has offered nothing to rebut the testimony of Mr. Shutt that an analysis of (1) Caribbean's gross profit percentages and percentages of labor cost to cost of goods sold and (2) petitioner's gross profit percentages and percentages of labor to cost of goods sold show that the formula retained its economic validity and that application of the formula resulted in arms-length pricing of the sales between petitioner and Caribbean.

In sum, we find no reason to alter the determination of the Administrative Law Judge that petitioner has offered sufficient proof to show that its intercorporate transactions with Caribbean were at arm's-length and that reporting on a separate basis resulted in a proper reflection of petitioner's tax liability.

We deal finally with the Division's assertion that petitioner has failed to distinguish the facts in this case from those in Matter of Standard Mfg. Co. v. Tax Commn. of State of New York (supra) involving the very same taxpayer.

We disagree.

In the prior litigation, petitioner did not challenge the ownership/control issue, but asserted that the State Tax Commission erred in finding that there was a unitary business and substantial intercorporate activity. The Appellate Division disagreed (Matter of Standard Mfg. Co. v. Tax Commn. of State of New York, supra, 498 NYS2d 724, 726). The court then went on to consider proof submitted by petitioner to prove there was no distortion as a result of intercorporate transactions and concluded "there is no proof that price adjustments pursuant to the [IRS] agreement were made for the years at issue" (Matter of Standard Mfg. Co. v. Tax Commn. of State of New York, supra, 498 NYS2d 724, 726). Here, petitioner has conceded the unitary business relationship between it and Caribbean and the substantial intercorporate transactions and concentrated on proof that those transactions were at "arms-length." Clearly, the record in this case is factually different because of the focus and nature of petitioner's arguments than the record in the prior litigation.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

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

3. The petition of Standard Manufacturing Co., Inc. is granted to the extent indicated in conclusions of law "H" and "I" of the Administrative Law Judge's determination, but such petition is otherwise denied; and

4. The Division of Taxation is directed to modify the notices of deficiency dated July 7, 1983 and August 18, 1983 issued to Standard Manufacturing Co., Inc. in accordance with paragraph "3" above, but such notices are otherwise sustained.

DATED: Troy, New York
February 6, 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