STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

SILVER KING BROADCASTING OF N.J., INC. : DECISION DTA No. 812589

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 August 31, 1989, August 31, 1990 and August 31, 1991. : :

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on August 10, 1995 with respect to the petition of Silver King Broadcasting of N.J., Inc., P.O. Box 9090, Tax Department, Clearwater, Florida 34618-9090. Petitioner appeared by KPMG Peat Marwick, LLP (Harold F. Soshnick, Esq., of counsel) and Ernst & Young (Russell D. Levitt, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (John O. Michaelson, Esq., of counsel).

The Division of Taxation filed a brief on exception. Petitioner filed a brief in opposition. The Division of Taxation filed a letter on November 27, 1995 stating it would not be filing a reply brief. This date began the six-month period for the issuance of this decision. Oral argument was not requested.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioners Koenig and DeWitt concur.

ISSUES

I. Whether petitioner, a second-tier subsidiary of a holding company with approximately 83 first- and second-tier subsidiaries, should be required to file corporation franchise tax reports on a combined basis with the holding company and all corporations included in the holding company's Federal consolidated return.

II. Whether, if reporting on a combined basis is required, the receipts factor should be adjusted to exclude from the numerator the sales of a nontaxpayer corporation which would otherwise be immune from New York corporation franchise tax pursuant to Public Law No. 86-272.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Petitioner, Silver King Broadcasting of N.J., Inc., is a Delaware corporation doing business in New York. Throughout the period in issue, September 1, 1988 through August 31, 1991, it was known and operated as HSN Broadcasting of New Jersey, Inc. From here on, petitioner will be referred to as "Jersey" or petitioner.[1]

Petitioner and the Division of Taxation ("Division") executed a stipulation of facts which included references to 68 exhibits. The stipulated facts have been incorporated into this determination; however, references to the exhibits and certain explanatory material have been omitted.

Jersey was a wholly-owned subsidiary of HSN Communications, Inc.,[2] which in turn was a wholly-owned subsidiary of Home Shopping Network, Inc. ("Network"). Network's predecessor, Home Shopping Channels, Inc., was incorporated in Florida in 1985 and later reincorporated in Delaware in 1986. Home Shopping Channels, Inc. merged into Network (with only Network surviving) on February 13, 1986. Network became a holding company as of January 1, 1988. It owns, directly or indirectly, the stock of a large number of affiliated corporations. In this determination, the terms "HSN" or "HSN affiliated group" will be used to

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[1]The facts as noted in this determination should be understood to apply to the audit period only. Subsequent events have substantially changed the nature of the corporate relationships described here.

[2]Silver King Communications, Inc. was previously known and operated as HSN Silver King Broadcasting Company, Inc., and throughout the audit period as HSN Communications, Inc.

refer to the entire group of Home Shopping Network affiliated corporations. According to Network's Federal returns, there were 66 corporations in the HSN affiliated group in 1988, 65 in 1989 and 82 in 1990.

The HSN affiliated group filed Federal income tax returns on a consolidated basis. The parties stipulated that Jersey and all other members of the affiliated group "meet the stock ownership requirement of Tax Law § 211.4 and 20 NYCRR 6-2.2 inasmuch as there was direct and/or indirect ownership of at least eighty (80) percent among all of them." The parties also stipulated that Network and the other members of the HSN affiliated group are engaged in a "unitary business".

The primary business activity of HSN is the sale of retail goods. The vast majority of those goods are sold by way of television programs broadcast by Home Shopping Club, Inc. ("Club"), a Delaware corporation wholly owned by, and a first-tier subsidiary of Network.

For those unfamiliar with televised shopping programs, some description is in order. "The Home Shopping Club" is a television program, broadcast 24 hours per day, seven days per week, by Club. Its programming features hosts, sometimes celebrities, who promote products for sale by Club to television viewers. A customer can order a product by telephoning an 800 number that appears on the screen. The order is filled and shipped to the customer by the United States Postal Service or common carrier.

Club sells a variety of consumer goods through its live network programs which are transmitted on a full- or part-time basis to television broadcast stations, cable television systems and satellite dish receivers in the United States.

The Home Shopping Club programming is produced by Club and transmitted on three separate networks: HSN 1, HSN 2 and HSN Spree. At different times, these networks were named "HSC 1", "HSC 2", "HSN 4" or "HSC 4", respectively. They are referred to by their alternative names in the documents offered in evidence.

The day-to-day business activities of Network's unitary enterprise are performed by different members of the HSN affiliated group.

(a) The Television Broadcast Business. HSN Communications, through its 11 broadcast subsidiaries (including Jersey), owns 11 UHF television stations and one UHF satellite station. Each of the stations broadcasts The Home Shopping Club, almost exclusively. HSN Communications also owns interests in other television broadcast entities. Jersey is the only one of the television broadcast subsidiaries that does business in New York.

(b) Video Production Business. The video production of The Home Shopping Club is performed by HSN Telemation, Inc. ("Telemation"), also a wholly-owned subsidiary of Network. It is a production and post-production company with facilities in Chicago, Denver, Seattle and Ontario, California. Although a portion of its work is devoted to the business of the HSN affiliated group, it provides communication services to third parties as well. Telemation files a New York corporation franchise tax report on a separate basis.

(c) Telemarketing Services Business. At least three corporations provide telemarketing services to the HSN affiliated group. These services include taking and transmitting orders and credit card clearing services. One of these corporations, HSN Mistix Corporation ("Mistix"), was acquired from an unrelated third party in 1988. It provides campsite reservation services, primarily in California, and sports and entertainment ticketing services to third parties. At times during the audit period, Mistix provided order-taking services to the HSN affiliated group. Mistix files a New York corporation franchise tax report on a separate basis.

(d) Catalog Sales Business. HSN Mail Order, Inc. markets products offered for sale over The Home Shopping Club through a mail order catalogue. "HSN Mail Order utilizes information in the Home Shopping Club database to target its mailings to Club Members" (Home Shopping Network, Inc., 1990 Annual Report, p. 10).

(e) Warehousing and Distribution Business. HSN Fulfillment, Inc., a wholly-owned subsidiary of Network, operates warehousing and distribution centers in four locations through four different subsidiaries (which will be referred to collectively, with their parent, as "Fulfillment"). Fulfillment maintains over 1,000,000 square feet of warehouse space from which merchandise orders are shipped. Fulfillment is linked to the HSN affiliated group's computer center enabling the immediate shipment of merchandise to customers throughout the country. A subsidiary of one of the Fulfillment corporations, Citrus Office Supply, Inc., is a wholesale supplier of office products which sells its products only to members of the HSN affiliated group.

(f) Voice Processing Systems. Precision Systems, Inc. was acquired by Network in 1987 to develop a voice processing system. This involves digitalizing the human voice and providing a direct link between a computer data base and a telephone caller. In Network's 1990 fiscal year, this system was marketed to long distance carriers and regional Bell operating companies (with an unknown degree of success).

(g) Retail Outlets. Excess product not sold through The Home Shopping Club or the mail-order catalogue business may be sold through four subsidiaries of Home Shopping Club Outlets, Inc. (a Network subsidiary) which operate retail stores in Florida.

(h) Cosmetics Business. A line of cosmetics sold exclusively through the HSN affiliated group were developed by a Network subsidiary, Noblene, Inc. Noblene ceased operations in 1990.

(i) Health Services Business. This aspect of the HSN affiliated group business is operated primarily by five second-tier subsidiaries: Redi-Med, Inc., which repackages bulk pharmaceuticals into dose packages which are sold to physicians, along with prepackaged pharmaceuticals, for resale to their patients; HSN Pharmaceuticals, Inc., which operates a mail-order pharmacy; HSN Health Assist, Inc., which developed a drug utilization review software system and a claims processing software system for prescription drugs which is marketed to health service providers; HSN Vision Club, Inc., which sells contact lenses, glasses and other eye care products through mail order; and Lifeway Health Products, Inc., which sells vitamin and mineral supplements and other health-related merchandise through The Home Shopping Club, Home Shopping Club mail-order catalogues, and retail outlets and third parties. The five subsidiaries were indirectly owned by Network, although direct ownership of the corporations shifted during the period of the audit. HSN Vision Club, Inc. was liquidated on August 27, 1990, and HSN Pharmaceuticals, Inc. was liquidated on April 16, 1991. Redi-Med, Inc. filed New York corporation franchise tax reports on a separate basis.

(j) Infomercial Business. "Infomercials" are, essentially, commercials for specific products packaged as short-form (30 to 120 seconds) or long-form (15 to 30 minutes) information programs. HSN Entertainment, Inc. designs, develops and procures products to be marketed in this manner. HSN Infonet, Inc. produces and distributes 24 hours a day long-form infomercials and other programming via satellite. Infonet, Inc. began broadcasting on September 1, 1991. Both corporations are wholly-owned Network subsidiaries.

(k) Real Estate Business. Network's real estate business is conducted by HSN Realty, Inc., Network's wholly-owned subsidiary, and Anwar Realty, Inc. ("Anwar"), HSN Realty's subsidiary. These corporations own all of the facilities housing Network operations. Facilities not used entirely by Network or other members of the HSN affiliated group are rented to third parties. The net operating expenditures of HSN Realty and Anwar are charged to Network. Network provides corporate services to these subsidiaries at no cost. HSN Realty filed New York corporation franchise tax reports on a separate basis.

(l) Credit Card Processing. HSN Credit Corporation, Inc. provides services which include electronic credit authorizations and financial clearing and chargeback processing. Services are provided to members of the HSN affiliated group and third-party clients. HSN Credit Corporation filed New York corporation franchise tax reports on a separate basis.

(m) Transportation Services. HSN Transportation, Inc., a wholly-owned subsidiary of Network, operates through three of its own subsidiaries. It provides services to Network and the

HSN affiliated group including: ownership of the corporate aircraft, over-the-road trucking services at the Fulfillment centers and automotive repair. The net operating expenditures of these subsidiaries is charged to HSN. HSN provides corporate services to these subsidiaries at no cost.

(n) Travel Business. Network's travel business is conducted by HSN Travel, Inc. through three second-tier subsidiaries. HSN Tours, Inc. offers travel arrangements and tours through the Home Shopping Travel Club which is promoted on Network television programs. World Rez, Inc. develops and markets travel products on a wholesale basis to travel agencies and business clients, including Network and members of the HSN affiliated group.

(o) Financial Services Business. Network's financial services business is conducted by HSN Financial Corp., Inc, a wholly-owned Network subsidiary, through four second-tier subsidiaries: HSC Financial Services, Inc., Home Shopping Club Securities, Inc., HSN Financial Planners, Inc., and HSN Brokers, Inc. HSN Brokers is the only one of the four still in operation after July 9, 1990. It operates one seat on the American Stock Exchange and two seats on the New York Stock Exchange, trading for other registered brokers (rather than individual investors) and collecting a commission on its trades. HSN Financial Corporation and HSN Brokers, Inc. filed New York corporation franchise tax reports during the audit period on a separate basis.

Network provides general corporate support services to its subsidiaries including: accounting, budget, tax, payroll, treasury, data processing, computer support, security, mailroom, facilities management, training, human resources and legal support. Jersey did not compensate Network for the support services provided to it.

Twelve of the corporations that make up the HSN affiliated group file New York State corporation franchise tax reports on a separate basis.

The Internal Revenue Service has never conducted an Internal Revenue Code § 482 or similar audit concerning intercompany pricing of the HSN affiliated group.

Jersey is a broadcast direct subsidiary of HSN Communications. It was incorporated in Delaware on July 28, 1986. In July 1986, Jersey purchased the assets (including FCC licenses) of then stations WWHT (Channel 68, later renamed WHSE) and WSNL (Channel 67, later renamed WHSI) from Wometco WWHT Inc., an unrelated party. This purchase was part of a nationwide effort by Network to purchase UHF television stations in principal markets throughout the United States.

No entity within the HSN affiliated group sold, spun-off or otherwise disposed of a television broadcast subsidiary during the audit period.

Jersey operates a television station (WHSE-TV, Channel 68) with a primary office in Newark, New Jersey. It also operates a station (WHSI-TV, Channel 67) with a small office in Smithtown, New York. Jersey began doing business in New York on October 3, 1986.

Throughout the audit period Jersey's day-to-day operations were conducted independently. In each of its fiscal years, it employed between 19 and 22 employees. These included a station manager, chief engineer, two program directors, a business manager, a traffic manager, maintenance engineers, a receptionist and technical operators. Four of these employees were assigned to WHSI in Smithtown, New York: a program director, two technical operators and a maintenance engineer.

Jersey owns an unmanned transmitter on Long Island and antennas on the World Trade Center and the Empire State Building in New York City.

The vast majority of Jersey's programming consisted of broadcasting The Home Shopping Club; however, it did carry a limited amount of other programming. In the year ending August 31, 1989, WHSI of Smithtown New York broadcast 31 hours and 51 minutes of taped programming originating from its own New York facilities. It carried 24 hours and 3 minutes of such programming in the year ending August 31, 1990, and it carried 24 hours and 43 minutes of original programming in the year ending August 31, 1991. WHSI also originated 9 minutes of live programming in 1991 consisting of live local election updates. The parties stipulated that "[a]ll other programming broadcast by WHSI was simultaneous re-transmission (satellite i.e., simulcast) of HSN 2 [Home Shopping Club programming] as carried by WHSE." However, further stipulations establish that Jersey broadcast a limited amount of other non-HSN programming which was re-transmitted by WHSI. Original programming broadcast by WHSI was produced in order to comply with FCC regulations.

Jersey received additional compensation from unrelated parties for airing non-HSN programming (primarily religious programs on Sunday mornings). The amount received was $244,000.00 in the fiscal year ended August 31, 1989; $254,000.00 in the fiscal year ended August 31, 1990; and $247,000.00 in the fiscal year ended August 31, 1991. These programs originated from Jersey's studio in Newark, New Jersey and were simulcast over WHSI-TV.

During the audit period, Communications and its broadcast subsidiaries acquired children's programming from Great Plains National (an unrelated party) for a total cost of $5,165.00. This cost was divided among all of the broadcast stations. The total cost to Jersey was $430.00.

Jersey broadcast almost exclusively the retail shopping program (HSN 2) produced by Club. There was no written contract between Club and Jersey concerning Jersey's broadcasting of the HSN 2 network programming. According to the parties' stipulation, Club paid Jersey "a 5% commission of HSC's net merchandise sales from the broadcasting of the HSN 2 network within the Arbitron rating service 'area of dominant influence' ('ADI') of stations WHSE and WSHI" (Stipulation, ¶ 32). Jersey reported commissions received from Club as gross receipts on its Federal pro forma 1120 income tax returns.

The broadcast guidelines imposed by the FCC on Club and Jersey were the same as those imposed on other unaffiliated broadcasters with contracts with Club. Jersey's FCC license was considered to be a valuable asset of the HSN affiliated group, and one of Jersey's responsibilities was to protect that license by meeting all FCC requirements. Operational control of television stations WHSE/WHSI by Jersey was essential to maintaining the license. For that reason, the operations of the television stations were kept separate and distinct from Network's control.

In 1993, the Division conducted an audit of Jersey and the other members of the HSN affiliated group. At that time there were 11 HSN corporations (in addition to Jersey) filing New York corporation franchise tax reports on a separate basis: Network, HSN Redi-Med, Inc., HSN Holdings, Inc., HSN Credit Corporation, Inc., HSN Communications, Inc., HSN Telemation, Inc., HSN Realty, Inc., HSN Financial Corporation, HSN Brokers, Inc., Home Shopping Club Securities, Inc. and HSN Mistix Corporation.

The audit was conducted primarily in Network's Florida headquarters over a period of about four days. The auditors did not visit Jersey's offices, meet with any Jersey employees or review the separate books and records of Jersey. The auditor's handwritten contact sheet (attached to Network's field audit reports) indicates that approximately 7.5 hours were spent in the field auditing Jersey specifically. It would appear that the only records reviewed were the HSN affiliated group's Federal consolidated tax returns and Jersey's New York State tax returns which included a Federal pro forma return. The Division determined that the income of Jersey was inaccurately reflected on a separate basis and recomputed Jersey's income on a combined basis with the entire HSN affiliated group.

The audit revealed that Network either directly or indirectly owned substantially all of the capital stock of the subsidiary corporations which the Division included in the combined report. Moreover, the Division determined that the HSN affiliated group conducted a unitary business, identified as electronic retailing. The Division concluded that each subsidiary either provided a direct service constituting a necessary component of the electronic retailing business or carried on a business complementary to the electronic retailing business. The parties have stipulated that the HSN affiliated group carried on a unitary business during the audit period.

The Division also found that there were substantial intercorporate transactions between the companies in the HSN affiliated group. With respect to Jersey, the auditor specifically identified only one type of intercorporate transaction: the 5% commission fee paid by Club to Jersey.

The Jersey Field Audit Report notes that Jersey and several other broadcasting subsidiaries receive almost 100% of their receipts from Club for rebroadcasting Club's programming. From this, the auditor concluded that "[n]one of the Broadcasting Companies would be able to survive without intercompany income from Home Shopping Club, Inc." The auditor also concluded that the 5% commission fee received by Jersey from Club would not be enough for the broadcasting companies to survive on their own. The Division concluded that this 5% fee was not an arm's-length transaction.

The Division also identified certain intercompany loans as creating distortion of New York income. Jersey carried a liability of about $22,000,000.00 in each of the audit years (described as "other liabilities" on the Federal returns). The exact amounts as shown on Schedule L of Network's Federal income tax returns were as follows:

Period Ending	Beginning of Year	End of Year
August 31, 1989	$23,897,534.00	$23,397,250.00
August 31, 1990	$23,397,250.00	$22,074,518.00
August 31, 1991	$22,074,521.00	$21,510,223.00

In each of the audit years, a Supporting Statement backing up ScheduleL shows the source of the beginning of the year liabilities as follows:

	August 31, 1989	August 31, 1990	August 31, 1991
Interco. recvble:	$-6,827,629.00	-$10,607,935.00	-$14,836,704.00
Interco. liability:	30,725,163.00	34,005,185.00	36,911,222.00
Total	$23,897,534.00	$23,397,250.00	$22,074,518.00

In each of the audit years, a Supporting Statement backing up Schedule L shows the source of the end of year liabilities as follows:

	August 31, 1989	August 31, 1990	August 31, 1991
Interco. recvble:	-$10,607,935.00	-$14,836,704.00	$ --
Interco. liability:	34,005,185.00	36,911,222.00	21,510,223.00
Total	$23,397,250.00	$22,074,518.00	$21,510,223.00

It was the Division's position on audit that these negative receivables and liabilities demonstrated distortion. The Division viewed the distortion as going in two directions. Since, according to the Division, the 5% commission was not paid out but accrued as an intercompany receivable, Network had the use of the commission fee monies without paying interest. Likewise, monies borrowed by Jersey from Network are loaned without interest. As the figures above illustrate, the accrued commission fees were used to pay down Jersey's liability to Network, but, in the interim, both parent and subsidiary appear to benefit from interest-free use of money that is reflected in the balance sheets as other liabilities. The auditor testified that he was not furnished with documentation showing the source or nature of these intercompany accounts, but he conceded under cross-examination that he had never requested such documentation.

The Division also noted that Network provided tax preparation, accounting and payroll services to Jersey for which it received no reimbursement or payment.

The Division concluded that there was a "severe interdependency" between Network and its subsidiaries. Examples of this dependency were found in the typical sales transaction where a customer sees a product displayed on a broadcast television station owned by one subsidiary, telephones an order to a second subsidiary, and has the order filled and shipped by a third subsidiary. An integrated computer system allowed Network and its subsidiaries to carry on this electronic retail business. The audit report states:

> "In this transaction there are exchanges of value occurring that cannot be measured. It is the inability to measure exchanges of value from one corporation to another which constitutes distortion."

In testimony, the auditor identified Network's centralized management system, especially cash management, as evidence of distortion of income. As an example, the auditor noted that the amount of cash retained by Jersey as an asset did not change significantly from year to year. The consolidated balance sheet submitted with Network's Federal income tax return for 1988 (the period ending August 31, 1989), Schedule L, shows that Jersey's beginning-of-year cash balance was $117,075.00 and its end-of-year cash balance was $5,200.00. The corresponding documents for 1989 show that Jersey's beginning-of-year balance was $5,200.00 and its end-of-year balance was $5,800.00. The Schedule L for 1990 shows Jersey's beginning- and end-of-year balances as $5,800.00. These relatively low cash balances reflect Network's corporate policy of controlling the cash of its subsidiaries. It was the Division's position on audit that the consistency of the cash balances from year to year indicates that the amount of income earned by Jersey was controlled by Network.

As a result of its audit, the Division issued to Jersey a Notice of Deficiency for the fiscal years ending August 31, 1989, August 31, 1990, and August 31, 1991, asserting deficiencies of corporation franchise tax and the metropolitan transportation business tax surcharge in the amount of $763,992.00, plus interest.

Kevin J. McKeon, Network's current treasurer and vice-president of accounting and finance, explained Network's centralized cash management system. Simply put, all of the money for the consolidated group was put in a "locked box" under Network's control. Network paid expenses on behalf of each subsidiary and invested the cash of the consolidated entity. In Jersey's case, all expense bills were submitted to the broadcast station itself. Jersey employees coded the bills by account codes set up by Network and sent the bills by Federal Express to Network in Florida. Network then paid the expense using a check with Jersey's name on it. Network prepared Jersey's Federal income and New York State corporation franchise tax reports. Jersey did not pay Network a fee for these services.

Mr. McKeon described the rationale for maintaining a centralized cash management system as follows:

> "As an entity with 84 different subsidiaries, it is prudent on our behalf to have a centralized cash management function. I couldn't imagine having 84 different checking accounts with 84 authorized signers or 168 authorized signers, as most accounts require two signers.
>
> "Cash is an asset of the corporation. As an asset, that has to be protected. To have it centralized within the corporate area is a prudent use of funds.
>
> "You also get economies of scale. To have checking accounts all over the country earning no interest -- one of the premises of our cash is that we earn interest on it. The more cash we have within a particular institution, we tend to get a higher rate. The more checks we cut within a particular banking institution, we tend to get a higher rate. So, it was not only protecting the assets, it was maximizing the interest income and costs associated with cutting those checks" (tr., p. 157).

Although most expenses were paid from one or more Network central accounts, imprest accounts were established for each subsidiary, with relatively small checking account balances (about $5,000.00) which the subsidiary used to pay routine small expenses. Mr. McKeon gave the example of an emergency plumbing bill.

Mr. McKeon also explained the nature of the liability owed by Jersey. In order to finance the purchase of the television broadcast stations by HSN Communications, Network secured $250,000,000.00 worth of debt. A portion of that money went from Network to HSN Communications to Jersey which used the money to acquire the two broadcast stations, WHSE and WHSI. The $34,000,000.00 intercompany liability was the result of this transaction and appeared in the Federal income tax returns as a loan from Network to Jersey. As Jersey earned income from the 5% commission paid by Club, its liability to Network was reduced. By the end of the audit period, the liability was reduced to $21,510,233.00. There were no contracts, notes, or loan documents evidencing these arrangements; however, Mr. McKeon testified that there is extensive documentation to back up the transactions. The Federal income tax returns reflected these arrangements.

John Riley, Network's Director of Taxation, testified that the 5% commission fee paid to Jersey by Club was recorded on Jersey's books. Intercompany transactions (e.g., Club's payments to Jersey, Jersey's payments to Network) were accomplished via journal entries through the intercompany accounts.

Nine of Jersey's employees were members of labor unions, and Jersey had collective bargaining agreements with three labor unions.

As noted, Jersey employed a station manager and business manager. Neither Network nor Club became involved in the day-to-day operations of Jersey. Mr. McKeon testified that Network did not have the expertise to operate a television broadcasting station. Jersey had a bank account in New Jersey which was used by the business manager to pay small expenses. Jersey prepared its own annual budget which was presented to Communications which presented it in turn to Network's budget committee.

With a cover letter dated January 19, 1989, the Washington, D.C. law firm of Dow, Lohnes & Albertson filed a license renewal application with the FCC on behalf of WHSE(TV). The law firm informed the WHSE station manager of the filing of the application by letter dated January 19, 1989. A Broadcast Equal Employment Opportunity Report for WHSE accompanied the license application. A filing fee of $30.00 was paid at that time by check drawn from Jersey's imprest account with the Midlantic National Bank of Newark, New Jersey.

Dow, Lohnes & Albertson also filed a license application on behalf of WHSI(TV) in January 1989. It also was accompanied by a check in payment of the license fee drawn on the Midlantic National Bank account and a Broadcast Equal Employment Opportunity Report. The station manager was informed of the filing of this license by the law firm.

Network began nationwide transmission of HSN 1 to cable television systems and satellite dish receivers on July 1, 1985. Since its inception, HSN 1 has been designed to serve the cable industry exclusively.

In September 1986, Network began transmitting HSN 2. HSN 2 has been designed to serve the television broadcast media primarily and to be operated in accordance with FCC regulations. HSN 2 appeared primarily on television broadcast stations, both those owned and operated by Network, and unrelated stations. HSN 2 was carried by cable television systems also, but from September of 1986 on, cable systems carrying HSN 2 were merely retransmitting the broadcast signal of a broadcast television station carrying HSN 2.

Initially, HSN 2's programming offered higher-priced, more innovative merchandise as compared to that offered on HSN 1. However, with the inauguration of Network's plan to acquire television broadcast stations in principal U.S. markets, distinctions in price and character of goods sold were eliminated.

In September 1987, Network initiated transmission of the HSN Spree programming network which is carried by broadcast television stations and cable systems.

Club has agreements with various cable operators outside the HSN affiliated group to carry Home Shopping Club programming on a full-time or part-time basis. Network (later, Club) entered into "affiliation" agreements with unrelated cable system operators to carry HSN 1, HSN 2, or both services. The standard affiliation agreement with those cable systems provided that the cable operator's compensation for carrying these services would be calculated at 5% of the net sales of merchandise sold by Network (or Club) to customers located within the cable operator's ADI.

Cable system operators which agreed to carry HSN 2 were compensated for all sales of HSN merchandise sold within their franchise area. Club agreed to pay such compensation whether the sale resulted from a customer watching the HSN 2 broadcast on the cable operator's system; on a television broadcast station owned by or affiliated with Network (but carried by the cable operator on its system); or by pulling in the HSN 2 broadcast on a home satellite dish.

In addition to the 5% fee, Club granted certain cable operators options to purchase Network common stock. The stock option grants were given in exchange for the commitment by these cable operators to carry Home Shopping Club programming to an agreed-upon minimum number of cable subscribers for a minimum period of time (three to five years).

HSN Spree was intended to be an overnight service which would fill the void left when most television networks stop broadcasting. The standard compensation paid by Club for carrying HSN Spree was 5% of Club sales made in the broadcast station's ADI. Club has entered into agreements with unrelated broadcast television stations to carry HSN Spree. The parties entered into evidence seven television affiliate agreements that reflect the arrangements described here.

Cable operators may also receive a commission on HSN Spree sales made within their franchise area if the cable system carries a broadcast station which televises HSN Spree in the same franchise area.

Network pioneered the 5% commission arrangement with cable systems operators and that fee became the standard for the industry. In its Annual Report to the Securities and Exchange Commission (Form 10-K) for the fiscal year ended August 31, 1988, CVN Companies, Inc., a Network competitor, described a business which is operated in substantially the same way as Network's business. The annual report states as follows:

> "Effective August 31, 1987, the Company entered into affiliation agreements with 19 operators of multiple cable television systems (the 'Affiliation Agreements') estimated to be serving approximately 16,000,000 subscribers located in all 50 states . . . . The Affiliation Agreements provide for carriage of the CVN program on a full-time (24 hours per day, seven days per week) non-exclusive basis through August 31, 1994. Each Affiliation Agreement requires the Company to pay to the Cable Affiliate a 'commission' equal to 5% of the net sales of merchandise sold via CVN programming to subscribers served by the Cable Affiliate's cable system." (CVN Companies, Inc.,

Annual Report to the SEC, Commission File No. 0-12163, p. 9-10.)

QVC Network, Inc., another Network competitor, also reported paying an annual 5% commission fee to cable system operators carrying QVC home shopping programs (QVC Network, Inc., Annual Report to the SEC for the fiscal year ended January 31, 1989, Commission File No. 0-14999).

Throughout the audit period, the highest contracted for hourly rate paid by Club to an uncontrolled television broadcast affiliate for carrying the HSN 2 programming network was $260.00 which was paid to Pan Pacific Television, Inc. ("Pan Pacific"), licensee of a station (KSPT-TV, Channel 66), serving the San Francisco, California ADI area. Until January 1, 1989, the hourly rate paid to Pan Pacific Television, Inc. by HSC was $210.00 an hour; from January 1, 1989 through the reminder of the audit period the hourly rate was $260.00.

HSN 1, HSN 2 and HSN Spree use the same program format, sell the same merchandise at the same price and fulfill orders through the HSN affiliated group system. There is no difference in the programming carried by the three networks.

At the time of the corporate reorganization of Network and the purchase of the HSN Communications broadcast subsidiaries, Network considered the tax ramifications of these moves. Three internal corporate memoranda were entered into evidence, where the subject of Network's sales tax and corporate tax liabilities were discussed. In a memorandum dated March 6, 1987, R. Joseph Riley, Director of Taxation, stated that Network would be immune from taxation in all but three states under the provisions of Public Law 86-272. He also stated: "Prior to 8/31/87, [the Silver King subsidiaries] will be paid appropriate fees thus potentially generating additional state income taxes." In a memorandum dated October 9, 1987, Network's Associate General Counsel addressed the steps needed to avoid registering Club as a sales tax vendor in the various states. He suggested that Club "enter into an Affiliation Agreement with each Silver King subsidiary on the <u>identical</u> terms and conditions as the agreements used between HSN and outside cable TV operators (i.e., including provisions for the granting of options to HSC)" (emphasis in original). He also stated that payments should be made each month through intercompany charges. A third memorandum, dated January 22, 1988, discusses the 5% commissions paid by Club to the Silver King subsidiaries. As relevant here, it states:

> "During the course of the corporate reorganization, it was decided that HSC (HSN prior to 12/31/87) should pay a commission to the Silver King stations similar to that paid to independent cable operators (i.e. 5% of sales by ADI). The rationale for this decision was to operate each subsidiary as an independent company which would strengthen our arguments in the sales tax battles and in any unitary issues that would arise.
>
> "Attached is a copy of a letter from Jim Flynn wherein he indicates that BMI would include these commissions in the receipt factor thus costing each station a .4% fee on these amounts.
>
> "Jim proposes that we make 'off-book' entries to record these commissions. In other words, they would be reflected on our internal financials and on the tax returns but not on the general ledger of each station. I presume that this approach would mean that the commissions would not be paid (offset the intercompany account).
>
> * * *
>
> "Since the HSN group would not lose any money by paying the commissions, we should proceed as planned. If we were to use the 'off-book' approach, I question whether this would avoid a BMI claim that they are owed the .4%."

Mr. Riley testified that the commissions paid by Club were accomplished through journal entries to the intercompany accounts. There were no "off-book" payments made.

To establish that the 5% commission fee paid by Club to Network was arm's length, petitioner offered the expert testimony and written report of Charles H. Kadlec of Charles Kadlec & Associates. Mr. Kadlec has 30 years experience in the financial and economic aspects of the communications industry in the United States. From 1964 to 1975 he was employed by CBS, Inc., Television Stations Division. He was named comptroller of that division in 1968 and director of planning and administration of owned-station WBBM-TV in 1971. He was vice-president and chief financial officer of WGN Continental Broadcasting for the Tribune Company from 1975 to 1979. From 1979 through 1988, he was employed by Frazier, Gross & Kadlec, Inc., a company which was founded in 1946 and provided valuations, appraisals, economic feasibility studies and financial management consulting to communications clients. He was named president of that corporation in 1982. In his position, he personally inspected more than 400 and valued more than 1,000 broadcast stations, cable television systems and telecommunications properties throughout the United States and Canada. At present, he is president of Charles Kadlec & Associates. The services provided by that firm include acquisition and economic consulting, appraisals, operations reviews and market/competitive feasibility analyses for communications industry clients. As president of Charles Kadlec & Associates, he has valued upwards of 200 broadcast, cable and newspaper entities. He was qualified to testify as an expert in the field of broadcast and cable television matters as they pertain to financial arrangements, appraisal of assets, and valuations.

Mr. Kadlec was asked by Network to determine whether the agreement between Club and Jersey "could be construed as 'arm's-length'" (Report of Charles Kadlec & Associates, August 1994, p. 2; hereinafter, the "Kadlec Report"). He concluded that the 5% revenue agreement "is equivalent to the agreement that would have been struck in an arm's-length third party negotiation between HSC and a prudent, fully informed and unrelated New York market UHF television station operator in the mid 1980's" (Kadlec Report, p. 3).

As background to his conclusions, Mr. Kadlec noted that there was an explosion of local television stations in the 1980's. The licensing of ultra high frequency (UHF) channels underwent tremendous growth--from 224 stations in 1980 to 540 by 1990. There was insufficient traditional entertainment programming to serve all these stations. Network saw in this situation an opportunity to reach a larger audience, not serviced by cable television, by acquiring television broadcast stations.

Kadlec compared the 5% revenue agreement between Club and Jersey with Club's cable system affiliation agreements. In his report, Mr. Kadlec stated that to Network the role played by a cable system and a television broadcast system is very similar. The purpose of both is to transmit Club's programming. Since the purpose of each mode of transmission is similar, he deemed it appropriate to compare the fee received by Jersey with fees paid to cable system operators. In general, Club's standard affiliation agreement with cable operators provided compensation for carrying HSN 1 and HSN 2 programming at a rate of 5% of the net sales of merchandise sold by Club to customers in the cable system's ADI.

As noted earlier, the 5% fee was the standard for the industry. Two television shopping networks in competition with Network adopted the 5% fee with their own affiliates.

Mr. Kadlec reviewed Network's affiliation agreement with Continental Cablevision, Inc. ("CCI") executed in July 1986. He noted that at that time CCI was the fifth largest multiple cable system operator in the United States. CCI was completely independent of Network. In return for carrying Club programming, Network agreed to pay CCI the standard 5% commission fee. Mr. Kadlec testified that in the 1980's cable systems typically had limited capacity so they could not carry all programming available. Moreover, the FCC must-carry rules required cable operators to carry local over-the-air signals, reducing the number of optional channels available. Thus, new networks competed for affiliation agreements with cable operators. Finally, cable operators usually have a monopoly within any given locality. Based on these factors, Mr. Kadlec thought it to be expected that a cable operator would have greater negotiating power and be able to strike a more favorable bargain than a broadcast station.

Mr. Kadlec's report did not note that the CCI agreement provided additional compensation to CCI in the form of a stock option agreement. The stock option agreement committed CCI to carry Network's programming for a period of three years. In addition, the standard affiliation agreement executed by CCI and Network obligates Network to provide market support for its programming. Specifically, Network agreed to an annual advertising budget of $.10 per subscriber to be spent by Network on local cable guide advertising within CCI's system. CCI agreed to include Network's marketing and promotional materials in its billing statements a minimum of four times per year, to permit Network to mail marketing materials to its subscribers a minimum of four times per year and to air 50 of Network's 60 second promotional announcements monthly within other cable programming. There were other optional incentive programs set out in the agreement. Mr. Kadlec did not comment specifically on these arrangements. He did not state whether he found it significant that Jersey and Network never executed a written agreement identical to Network's typical affiliation agreement.

In 1986, Network entered into an affiliation agreement with Pan Pacific, licensee of broadcast television station KPST-TV, Channel 66. Mr. Kadlec compared the agreement between Network and Jersey with the Pan Pacific agreement. He began his analysis with a review of the San Francisco television market in the late 1980's. During that period, San Francisco had four dominant commercial VHF television stations, affiliated with ABC, CBS and NBC, and 10 commercial UHF stations including Channel 66. In 1988, the four VHF stations attracted about 78% of the market, billing approximately $314,000,000.00 of the total $397,000,000.00 expended by advertisers on San Francisco television stations. That left approximately $83,000,000.00 for the 10 UHF stations to fight for. Four of those stations dominated the market. The remaining 6 stations (including KSPT-TV) each attracted less than 1% of San Francisco's television viewing.

The 1986 agreement between Pan Pacific and Network provided for the sale to Network of blocks of time on KSPT-TV. KSPT-TV agreed to air HSN 2 for 148 hours per week (KSPT-TV reserved 20 hours per week for other programming of its choice). In return, Network agreed to pay KSPT-TV $210.00 per hour of air time. This guaranteed Pan Pacific $1,616,160.00 annually in fees (an amount equal to .40% of the San Francisco television revenue market in 1988). Effective January 1, 1989, the agreement was amended to provide an increase in the hourly rate to $260.00, yielding an annual revenue to Pan Pacific of about $2,000,000.00. Mr. Kadlec prepared a chart which shows KSPT-TV's revenues from Network as a percentage of the San Francisco television market as follows:

" [Category]	1988	1989	1990
San Francisco Market Revenues (millions)	$397,200	$434,800	$471,750
KPST-TV Revenues from HSC (millions)	$1,616	$2,001	$2,001
HSC Revenues as percent of market	.41 percent	.46 percent	.42 percent"

Mr. Kadlec considered Channel 66 to be sufficiently similar to WHSE/WHSI to provide a fair comparison. The television market in New York in the late 1980's was even more competitive than the San Francisco market. The programming alternatives for WHSE/WHSI were limited and the stations were not profitable in the early 1980's. Mr. Kadlec prepared a comparison of Jersey's revenues from Network as a share of the New York market as follows:

" [Category]	1988	1989	1990
New York Market Revenues	$868,300,000	$948,500,000	$976,955,000
WHSE/WHSI Revenues from HSC	$3,750,000	$4,005,000	$4,150,000
HSC Revenues as percent of market	.43 percent	.42 percent	. 42 percent"

Based on the information conveyed in the two charts above, Mr. Kadlec concluded that Network's 5% formula to compensate Jersey "is consistent with the independent arm's-length agreement struck with San Francisco television station KSPT-TV in terms of both absolute market revenue percentage share as well as the improvement in this share before HSN involvement" (Kadlec Report, p. 20).

According to Mr. Kadlec's report, Channel 66 was completely independent of Network. The affiliation agreement was dated September 10, 1986 and amended in 1987, 1989, 1991 and 1992. A Memorandum Opinion and Order of the FCC states that Pan Pacific and Silver King Broadcasting of California (a Network subsidiary) reached an agreement for sale of the station on August 1, 1986 and executed a formal agreement for, among other things, the filing of an application to effectuate the sale of Pan Pacific stock to Silver King. That sale was never consummated, apparently because the FCC refused to grant the application.

Based on an analysis of Jersey's income and expenses for the years 1988 through 1991, Kadlec concluded that stations WHSE and WHSI operated profitably under the 5% fee arrangement. Comparisons with other UHF stations with more conventional programming showed that Jersey was more profitable than other UHF stations in the New York City area. This led Kadlec to conclude that "the revenue formula for television stations would not be greater than five percent of HSC sales to customers located within the WHSE/WHSI broadcast area under any circumstances" (Kadlec Report, pp. 24-25).

The following chart is a summary income statement for Jersey prepared by Kadlec based on WHSE/WHSI internal management reports:

TELEVISION STATION WHSE/WHSI
(FISCAL YEARS ENDING AUGUST 31, 1988, 1989, 1990 AND 1991)
In Thousands

	1988	1989	1990	1991
Revenues				
HSN Payments	$3,720	$3,780	$4,229	$4,079
Other[3]	935	674	625	658
Total Revenues	$4,655	$4,454	$4,854	$4,737
Operating Expense (Cash)				
Payroll	($ 807)	($ 744)	($ 776)	($ 770)
Engineering/Programming	(245)	(232)	(187)	(146)
Rent and Maintenance	(590)	(585)	(697)	(714)
Other Operating Expenses	(835)	(830)	(856)	(877)
Administrative Expenses	(150)	(250)	(239)	(177)
Total Operating Expenses	($2,627)	($2,641)	($2,755)	($2,684)
Operating Income	$2,028	$1,813	$2,099	$2,053
Operating Income Margins	43.6%	40.7%	43.2%	43.3%

Kadlec's report noted that the Home Shopping format allowed a television station to operate with minimal expenses for personnel, sales and promotion, administration or office and engineering supplies. Kadlec believed these reduced expenses would justify a pricing formula of no more than 5%.

[3]Total revenues as shown here are consistent with total gross receipts reported on Jersey's Federal returns for the years in issue. Revenues identified by Kadlec as "Other" (in actuality, third-party payments) do not equal the amounts stipulated to as "additional compensation" by the parties (Stipulation, ¶ 31). Mr. Kadlec was not able to explain the differences. Taken as a whole, the evidence shows that Jersey had additional revenues of about $400,000.00 to $450,000.00 per year which were not explained by evidence in the record.

The Division offered the testimony of Ronald Ginsberg, Chief of Transfer Pricing, Office of Tax Policy Analysis of the New York State Department of Taxation and Finance. Mr. Ginsberg's educational background, both at the undergraduate and graduate levels, is in economics. He served as a fiscal economist for the New York State Assembly from 1981 to 1987. Since 1987, he has worked for the Department of Taxation and Finance (with a year-long interruption to serve as a Project Director in the Division of the Budget). In his current position, he provides expert economic advice to the Division in the areas of corporate combination and transfer pricing. Mr. Ginsberg was qualified to testify as an expert in the general area of combined reporting. He also claimed to be an expert in the field of "transfer pricing", defined by him as "a type of pricing that occurs when you don't have a market to establish prices" (tr., p. 313). Although he conceded having no expertise in the field of communications or broadcasting, he stated that his expertise in the field of transfer pricing could be applied to any industry.

Mr. Ginsberg prepared a report analyzing "the economic interrelationships and transfers of value between and among the affiliates of the Home Shopping Network, Inc. during the period 1989 through 1991 in the context of a combined report for Silver King Broadcasting of New Jersey" (Ginsberg Report, September 20, 1994, p. 1). In testimony and in his report, Mr. Ginsberg expressed his opinion that Jersey's reporting of income on a separate basis resulted in distortion of income subject to New York State corporation franchise tax. His conclusion was based on the following factors.

(a) Mr. Ginsberg noted that Network is a unitary business and asserted that it is operated "in a manner which creates distortion of income as measured by the income as assigned by the corporation to the affiliate operating in New York" (Ginsberg Report, p. 13). According to Mr. Ginsberg, distortion of income is the result of functional integration of the HSN affiliate group, centralized management and control, vertical and horizontal integration of the group's business activities, and economies of scope and scale.

It is Mr. Ginsberg's opinion that WHSE/WHSI do not operate as typical broadcast television stations. "Rather they are captive passive electronic repeaters of the HSN programming material" (id.). He contrasted their operation with television stations which broadcast original or purchased programming that includes entertainment and news.

(b) Based on the internal corporate memorandum of January 22, 1988 (quoted in Finding of Fact "54"), the Ginsberg Report concludes that the 5% commission was not actually paid. The report states: "This 'off-book' method of accounting for intercompany flows of value distorts the income of the station in New York" (Ginsberg Report, p. 14).

(c) The Ginsberg Report concludes that there were substantial intercorporate loans which caused distortion of income. It states:

> "The company made what amounted to substantial loans to WHSE/WHSI. No interest was charged for these funds. The evidence of this intercompany flow of value is found in the intercompany liability entry in the supporting statement for Other Liabilities (Schedule L, Line 21) of the federal tax returns. The 1989 federal tax return shows an increase of approximately three million dollars during 1989. There is no commensurate interest expense. These intercorporate arrangements reflect functional integration and centralized financial management as well as centralized budget making and unified corporate management and strategic planning" (Ginsberg Report, p. 14).

(d) Mr. Ginsberg took issue with the conclusions of the Kadlec study concerning the 5% commission fee. He disputed Mr. Kadlec's assertion that affiliation agreements with cable system operators offered a reasonable comparison with Jersey and Network's agreement. Mr. Ginsberg states that a cable system and a broadcast television station are too dissimilar to compare. The report notes that a cable system offers its customers many networks to choose from, while a broadcast television station can offer only one network program at a time. Based on this difference, the Ginsberg Report concludes that any comparison between affiliation agreements with cable systems and broadcast systems is spurious.

The Ginsberg Report asserts that all cable system affiliation agreements provide for a stock option plan in addition to the 5% commission fee. Since Jersey was not offered such a plan, Mr.

Ginsberg concluded that its arrangement with Network was significantly different from that of the cable operators and not comparable. In his testimony, Mr. Ginsberg pointed out that there was no written agreement between Network and Jersey. Since the typical Network affiliation agreement contained provisions in addition to the 5% commission fee, he found that none of the affiliation agreements provided a reasonable basis for determining whether Network and Jersey's arrangements were "arm's-length".

Mr. Ginsberg pointed out that Network's agreement with Pan Pacific was for the payment of fixed amounts per hour rather than a commission fee. Because of this difference, he found the agreements between Pan Pacific and Jersey to be not comparable. He disputed Mr. Kadlec's assertion that KPST-TV was independent of Network, noting that applications for acquisition of KSPT-TV by Network had been made, or were soon to be made, at the time the affiliation agreements were executed.

Mr. Ginsberg testified that the affiliation agreements with unrelated broadcast television stations transmitting HSN Spree were not comparable to Network's arrangement with Jersey because the unrelated stations did not broadcast Home Shopping programs 24 hours per day as Jersey did.

To determine Jersey's entire net income subject to tax, the Division calculated the combined receipts factors as follows:

	8/31/89	8/31/90	8/31/91
Combined New York Receipts			
Home Shopping Club, Inc.	$ 78,475,778.00	$ 95,045,351.00	$ 92,864,444.00
HSN Broadcasting of New Jersey, Inc.	0.00	0.00	0.00
HSN Brokers, Inc.	100,692.00	284,982.00	179,849.00
Home Shopping Club Securities, Inc.	22,189.00	18,971.00	0.00
HSN Mistix Corporation	0.00	845,275.00	1,088,237.00
HSN Financial Corporation, Inc.	86,503.00	58,232.00	0.00
Total Combined New York Receipts	$ 78,685,162.00	$ 96,252,811.00	$ 94,132,530.00

Combined Everywhere Receipts			
Consolidated Receipts (Net)	$792,783,665.00	$1,029,913,380.00	$1,096,135,201.00
Gross Rents	645,308.00	791,111.00	754,915.00
Gross Royalties	580,848.00	550,539.00	993,366.00
Other Receipts	233,588.00	1,390,867.00	1,263,812.00
Total Consolidated Everywhere Receipts	$794,243,409.00	$1,032,645,897.00	$1,099,147,294.00
Combined Receipts Factor			
Combined New York Receipts Factor	$ 78,685,162.00	$ 96,252,811.00	$ 94,132,530.00
Combined Everywhere Receipts Factor	794,243,409.00	1,032,645,897.00	1,099,147,294.00
Combined Receipts Factor	9.9069%	9.3210%	8.5641%
Additional Combined Receipts Factor to Schedule C	9.9069%	9.3210%	8.5641%

Jersey's combined business allocation percentages were determined as follows:

	8/31/89	8/31/90	8/31/91
Combined Property Factor	3.0490%	2.4689%	2.1277%
Combined Receipts Factor	9.9069%	9.3210%	8.5641%
Additional Combined Receipts Factor	9.9069%	9.3210%	8.5641%
Combined Wage Factor	0.7939%	0.4171%	0.3781%
Total New York State Factors	23.6567%	21.5280%	19.6340%
Combined Business Allocation Percentage	5.9142%	5.3820%	4.9085%

As determined on audit, the entire net income of the HSN affiliated group was $11,999,911.00 for the fiscal year ended August 31, 1989, $56,077,854.00 for the fiscal year ended August 31, 1990, and $58,130,963.00 for the fiscal year ended August 31, 1991. Application of the business allocation percentages yielded total allocated income of $709,699.00, $3,018,110.00 and $2,853,358.00, respectively, for the three assessment years.

OPINION

Article 9-A of the Tax Law imposes a tax on every corporation for the "privilege of exercising its corporate franchise, or of doing business, or of employing capital, or of owning or leasing property in [New York State] in a corporate or organized capacity, or of maintaining an office in [New York State]" (Tax Law § 209[1]; 20 NYCRR 1-1.1). The basic premise is that every corporation is a separate taxable entity and must file its own report. However, the

Division, in its discretion, may require a group of affiliated corporations to file a combined report or may grant permission to a group of affiliated corporations to file a combined report (Tax Law § 211[4]; 20 NYCRR 6-2.1[a]).

To require or permit a combined report, the Division's regulations establish a stock ownership requirement (20 NYCRR 6-2.2[a]); a requirement that the group of corporations to be combined is engaged in a unitary business (20 NYCRR 6-2.2[b]); and an "other requirement" (20 NYCRR 6-2.3 [relating to taxpayers]; 20 NYCRR 6-2.5[a] [relating to foreign corporations]).

The "other requirement" is that the Division may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The regulations presume such distortion when the taxpayer reports on a separate basis "<u>if there are substantial intercorporate transactions among the corporations</u>" (20 NYCRR 6-2.3[a], emphasis added).

The presumption of distortion created by substantial intercorporate transactions may be rebutted by showing that the transactions which give rise to the presumption are arm's-length (<u>Matter of Standard Mfg. Co.</u>, Tax Appeals Tribunal, February 6, 1992). Internal Revenue Code § 482 adjustments may be used to show arm's-length pricing between related companies where a Federal audit has resulted in adjustments (<u>Matter of USV Pharm. Corp.</u>, Tax Appeals Tribunal, July 16, 1992; <u>Matter of Standard Mfg. Co.</u>, <u>supra</u>). In the absence of section 482 adjustments, it is appropriate to apply the principles of section 482 since that section shares a similar purpose with Tax Law § 211(4), i.e., the proper reflection of income (<u>Matter of USV Pharm. Corp.</u>, <u>supra</u>; <u>Matter of Sears, Roebuck & Co.</u>, Tax Appeals Tribunal, April 28, 1994).

Where a taxpayer fails to meet the presumption of distortion because it does not have substantial intercorporate transactions "and if the filing of a report on a separate basis nevertheless results in a distortion of such taxpayer activities in New York State, then the Division will permit or require the filing of a combined report" (20 NYCRR 6-2.3[d]).

The Administrative Law Judge first determined that petitioner (referred to as "Jersey") through the testimony and report of its expert witness, Mr. Kadlec, rebutted the presumption of distortion arising from the acknowledged intercorporate transaction between Jersey and Club, i.e., the 5% commission, by showing that the commission rate was consistent with the rate paid to uncontrolled cable systems operators and broadcast television stations, and was arm's length in accord with section 482 principles.

The Administrative Law Judge rejected the Division's assertion that the comparisons made by Mr. Kadlec in his report were not valid because the agreement between Jersey and Club was not in writing and, thus, impossible to compare with written affiliation agreements with uncontrolled entities. She noted that the parties stipulated that Jersey was paid a commission of 5%; thus, there was an agreement which was executed by the parties.

The Administrative Law Judge rejected the Division's assertion that the agreement could not be compared because it did not have a stock option.

> "The Division notes that in many cases cable systems operators were given stock options in addition to the 5% commission fee; however, the Division stipulated that the stock options were granted in exchange for commitments to carry Network programming 'to an agreed upon number of cable subscribers for a minimum period of time' (Stipulation ¶ 20). Again, because Jersey was a broadcast station it could not make such a promise. Moreover, stock options were not offered to all cable systems and unrelated broadcast affiliates. I fail to see how this difference in the terms of the agreement calls into question the arm's-length nature of the 5% fee" (Determination conclusion of law "D").

The Administrative Law Judge also rejected the Division's assertion that it was wrong for Mr. Kadlec to assume that cable operating systems and broadcast television stations are comparable.

> "The evidence shows that the 5% fee is an industry-wide standard with almost no variation regardless of whether the fee is paid to a broadcast station or cable systems operator. The Division finds the evidence regarding uncontrolled broadcast television systems to be lacking in comparability because those agreements were for carriage of HSN Spree for less than 24 hours per day, usually overnight. Again, the Division's logic escapes me. It would seem

> that a broadcast station with few other programming alternatives would be more than willing to carry HSN Spree for a fee. If anything, it could be expected that a broadcaster in this situation would receive a lower fee than a cable systems operator. But in both cases the same 5% fee was given. I cannot see how the variations pointed out by the Division undermine Mr. Kadlec's methods or conclusions" (Determination, conclusion of law "D").

Finally, the Administrative Law Judge rejected the Division's assertion that the broadcast station, KSPT-TV, relied upon by Mr. Kadlec in his report, was not an uncontrolled party. She found that the negotiations to buy the station were not completed and that while "the mere existence of such a plan may have had an influence on the relationship between Network and Pan Pacific, it can hardly be said that KSPT-TV was controlled by Network" (Determination, conclusion of law "D"). In any event, she concluded that even if the comparison with KSPT-TV were eliminated, "there would still be substantial evidence in the record that the 5% commission fee paid to Jersey was an arm's-length charge" (Determination, conclusion of law "D").

On exception, the Division asserts that "[d]ue to the increasing formality of the Division of Tax Appeals in conducting hearings regarding issues of combined franchise tax reports, both the taxpayers and the Division are forced to engage in a battle of 'expert witnesses'" (Division's brief, p. 8). The Division asserts that Mr. Kadlec "was hired to parrot" the taxpayer; that he received a fee for his report; that Mr. Kadlec "has no experience in establishing an arm's-length broadcast fee arrangement"; that he was not an expert in economics, that his "only expertise in economics arises from a few college courses during the 1950s" (Division's brief, pp. 8-9).

With regard to the substance of Mr. Kadlec's testimony and his report, the Division raises the same arguments on exception as it did before the Administrative Law Judge at hearing.

We affirm the determination of the Administrative Law Judge.

First, we find the Division's assertion concerning the "forced" use of expert witnesses to be totally without merit. There is no prescription for the use of expert witnesses from this Tribunal in this or any other case as is implied by the Division. The issue here is whether the 5% commission is distortionary. The fact that both parties chose to use an expert witness to establish the facts necessary to support their respective legal arguments is entirely their choice and, in our view, reflects the complexity of the subject and the adversary nature of the hearing process.[4]

Second, we find nothing in the record which causes us, in any way, to alter the acceptance by the Administrative Law Judge of Mr. Kadlec's qualifications as an expert witness. Mr. Kadlec has 30 years' experience in the financial and economic aspects of the communications industry in the United States. From 1964 to 1975 he was employed by CBS, Inc., Television Stations Division. He was named comptroller of that division in 1968 and director of planning and administration of owned-station WBBM-TV in 1971. He was vice-president and chief financial officer of WGN Continental Broadcasting for the Tribune Company from 1975 to 1979. From 1979 through 1988, he was employed by Frazier, Gross & Kadlec, Inc., a company which was founded in 1946 and provided valuations, appraisals, economic feasibility studies and financial management consulting to communications clients. He was named president of the corporation in 1982. As president, he personally inspected more than 400 and valued more than 1,000 broadcast stations, cable television systems and telecommunications properties throughout the United States and Canada. At present, he is president of Charles Kadlec & Associates. The services provided by the firm include acquisition and economic consulting, appraisals, operations reviews and market/competitive feasibility analyses for communications industry clients. As president of the firm, Mr. Kadlec has valued upwards of 200 broadcast, cable and newspaper entities.

Third, we find no fault with the Administrative Law Judge's analysis of the evidence submitted by the parties. In particular, we find nothing in the evidence offered by the Division to counter the fact that the 5% commission arrangement was the standard for the industry. We agree with the Administrative Law Judge that the comparisons done by Mr. Kadlec were valid

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[4]The audit manual of the IRS is instructive concerning the complexity of 482 examinations and the use of experts by IRS examiners (see, e.g., Internal Revenue Service Manual Handbook, HB 4233, June 1, 1994, Part IV Audit & Investigation).

for purposes of determining the arm's-length nature of the 5% commission and we find that the 5% commission was arm's-length for the reasons stated in the determination of the Administrative Law Judge.

The Administrative Law Judge next addressed the Division's assertion that the interest-free loans between the affiliated group and Jersey result in distortion. The Administrative Law Judge rejected the Division's assertion that the loans were never paid but were merely accrued as an intercompany liability. The "evidence shows that payments were made via postings to the intercorporate accounts" and that while the "Division noted that no interest was paid on these incorporate [sic] loans . . . [it] does not specifically explain how this results in distortion" (Determination, conclusion of law "E").

The Administrative Law Judge noted that "[p]etitioner does not claim that these transactions were at 'arm's length' under the section 482 regulations . . . [but that] there was no distortion of New York income as a result of these interest free loans or advances" (Determination, conclusion of law "E"). The core of petitioner's argument is that Jersey was a debtor in its relationship with the affiliated group. The fact that Jersey did not pay interest on the loans meant that there was no additional expense to reduce its New York income. The Administrative Law Judge rejected the Division's argument that "'[t]he proper goal in reporting as described by the Tax Law is the proper reflection of tax liability for New York purposes (Tax Law § 211.4), irrespective of whether the tax liability is overreported or underreported'" (Determination, conclusion of law "E," quoting Division's brief, p. 17). The Administrative Law Judge held, based on our decision in Matter of Campbell Sales Co. (Tax Appeals Tribunal, December 2, 1993), that the overstatement of New York income by Jersey is not distortion which provides a basis for requiring combined reporting. In so concluding, she noted that:

> "[t]he irony here is that in order to cure the distortion created by an overstatement of New York income the Division proposes to combine Jersey with about 83 other corporations and increase its

> tax liability by $764,000.00 in a three-year period. If an accurate reflection of New York tax liability is the goal, the Division could impute an interest deduction under the authority of Tax Law § 211(5). I do not find that the intercorporate loans are a basis for requiring combination" (Determination, conclusion of law "E").

On exception, the Division makes the same arguments it made at hearing.

We affirm the determination of the Administrative Law Judge.

In Matter of Campbell Sales Co. (supra), the Division argued that the fact that all of the petitioner's (Sales) activities related to marketing the parent's (Soup) products, coupled with the fact that it was guaranteed a profit, provided incontestable evidence of distortion and rendered an arm's-length analysis ineffective. We disagreed stating:

> "[i]n analyzing the Division's argument, we must first assume that such a profit guarantee would entitle petitioner to a smaller commission equivalent (due to the elimination of risk) than it would receive under an otherwise identical 'pure' commission arrangement. This would require a downward adjustment of the commission-equivalent rate in order to be properly aligned with the 'pure' commission from an arm's-length standpoint. Therefore, the only potential effect of the profit guarantee is that it caused petitioner's income and, thus, its tax liability, to be overstated. Because the Division does not explicitly argue that tax liability is not properly reflected within the meaning of section 211(4) where a taxpayer's income is overstated, and because the correctness of such a position is not obvious to us, we conclude, based on the record before us, that the overstatement of tax to New York State is not a basis to require combined reporting" (Matter of Campbell Sales Co., supra).

The result of the overstatement of New York income here is the same as it was in Campbell, namely, that petitioner's tax liability is also overstated. As in Campbell, the Division offers no rationale as to why such overstatement is distortion. Nor does it offer any explanation as to why the proper cure for this overstatement is to increase petitioner's tax liability through combination.

The Administrative Law Judge next rejected the Division's argument that the unitary business relationship between Jersey and the group may make it impossible to accurately reflect New York tax liability through separate accounting.

On exception, the Division argues that the presence or absence of substantial intercorporate transactions is not conclusive evidence of the presence or absence of distortion, but simply one scenario for requiring combination under the statute and regulations. The Division argues that the regulations address the permitted or required combination of an affiliated group where there are not substantial intercorporate transactions. [5]

In such cases, the Division argues that the applicable standard is "inherent distortion," which the Division defines "as the economic relationship between related entities that are so seamlessly integrated as to withstand any and all attempts to properly report their individual net incomes at arm's-length"[6] (Division's brief, p. 15). In this case, the Division asserts it has identified "distortive intercorporate transactions with its limited knowledge of the activities of the affiliated group. Such relationships and intercorporate transactions suggest that there are a myriad of additional transactions that the Division would be unable to identify without an incredibly burdensome, intrusive and disruptive field audit" (Division's brief, p. 25). The Division argues that "it is impossible for [it] to quantify each and every possible intercorporate relationship. <u>As long as the Division can demonstrate any possible distortion</u>, the burden the [sic] shifts back to the taxpayer to demonstrate that all of the corporate interrelationships are being conducted at arm's-length" (Division's brief, pp. 25-26, emphasis added). The Division argues further that "[t]he degree of centralization of management and the degree of functional integration that existed between HSN and its subsidiaries was such that it is impossible to

[5]20 NYCRR 6-2.3(d) provides that:

> "[i]f a taxpayer fails to meet the presumption of distortion because it does not have substantial intercorporate transactions . . . and if the filing of a report on a separate basis nevertheless results in a distortion of such taxpayer's activities, business, income or capital in New York State, then the [Division] will permit or require the filing of a combined report. If a taxpayer meets the presumption of distortion because it has substantial intercorporate transactions . . . and if the filing of a report on a separate basis does not result in a distortion . . . the [Division] will not permit or require the filing of a combined report."

[6]The auditor testified that, in his opinion, distortion of income is inherent in a unitary relationship.

separate, for accounting or tax purposes, the respective contributions made by each company to the value of the enterprise as a whole" (Division's brief, p. 26). The Division argues that it "demonstrated a number of areas where distortion exists. These items of distortion (e.g. no interest on loans, centralization of cash management without compensation, centralization of management without compensation, etc.) have been held by this Tribunal to support a finding of distortion (see e.g. Heidelberg Eastern, Inc. and East Asiatic Company, Inc., Tax Appeals Tribunal, May 5, 1994)" (Division's brief, p. 26).

The Division is correct, there are two scenarios for required or permitted combination -- presumption and non-presumption. In the presumption cases, the burden is on the taxpayer to show that the intercorporate transactions which give rise to the presumption are arm's-length in order to prove that reporting on a separate basis is a proper reflection of income.

Where the taxpayer rebuts the presumption of distortion, as it has in this case, and in the non-presumption cases, the Division, in order to require combination, must show why it believes that reporting on a separate basis does not properly reflect income (Matter of Standard Mfg. Co., supra; Matter of USV Pharm. Corp., supra; Matter of Sears, Roebuck & Co., supra; see also, 20 NYCRR 6-2.3[d]).[7]

[7]20 NYCRR 6-2.3(d) provides:

> "[i]f a taxpayer fails to meet the presumption of distortion because it does not have substantial intercorporate transactions with any corporation described in section 6-2.2 of this Part or with a combined or combinable group of such corporations and if the filing of a report on a separate basis nevertheless results in a distortion of such taxpayer's activities, business, income or capital in New York State then the [Commissioner of Taxation] will permit or require the filing of a combined report. If a taxpayer meets the presumption of distortion because it has substantial intercorporate transactions with any corporation described in section 6-2.2 of this Part or with a combined or combinable group of such corporations and if the filing of a report on a separate basis does not result in a distortion of such taxpayer's activities, business, income or capital in New York State, then the [Commissioner of Taxation] will not permit or require the filing of a combined report."

We agree with the Administrative Law Judge that this burden cannot be met simply by circling back to the same factors which established the existence of a unitary business enterprise, i.e., 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). As the Division's expert noted in his testimony, New York is not a unitary state and does not require combination on that basis alone.

> "[H]e identified what is needed as something less than substantial intercorporate transactions. As he put it, the Division must show 'not only is the relationship a unitary relationship, but the factors that created that unitary relationship also had enough of a tail, had enough of a bite, to create distortion of income in an attempt to measure the income separately' or, as he also stated, to demonstrate distortion '[y]ou had to be something like unitary and a Post-Toastee' (tr., p. 150)" (Determination, conclusion of law "F").

Using the Division's hyperbole, the Division has failed to prove the "Post-Toastee."

We agree with the Administrative Law Judge that in such cases it is not sufficient for the Division to:

> "merely identify possible areas of distortion. [The Division] must, as a minimum, identify with particularity the activities or transactions which it claims give rise to distortion and explain how distortion arises from those activities or transactions. To hold otherwise would create a second presumption of distortion for numerous, undefined, intercorporate transactions. The Division had the opportunity on audit to examine the books and records of Jersey and other members of the controlled group, to identify the number and amount of any transactions that occurred and to seek out information regarding the actual nature and extent of services provided by Network to Jersey. That information might have been used to demonstrate distortion, if it exists. The Division cannot simply point to the seamless operation of the unitary group and areas of possible distortion as it does here, and by that expedient place an insurmountable burden of proof on the taxpayer" (Determination, conclusion of law "F")

We also note that the Division misreads our decision in Heidelberg. Our decision in that case does not stand for the proposition that establishment of a unitary business relationship alone is grounds for combination. In Heidelberg, the corporations, i.e., EAC and Heidelberg, requested permission to file on a combined basis. The Division denied the request arguing that the corporations were not engaged in a unitary business. The Administrative Law Judge found that corporations proved they were engaged in a unitary business by showing flow of value between the corporations, unified cash management, and centralized management. Since the corporations did not assert that there were substantial intercorporate transactions between them during the audit period, they were not entitled to a presumption of distortion; their burden was to prove that filing on a separate basis was distortionary. The corporations proved distortion by showing that the factors which the Administrative Law Judge relied upon to find a unitary business relationship, were not carried on at arm's-length (the very thing the Division has failed to do in this case). We affirmed the determination of the Administrative Law Judge for the reasons stated in his determination.

In view of our decision that the Division cannot require combined reporting, we need not deal with the issue raised by petitioner in its brief in opposition to the Division's exception that the inclusion of Club's receipts from sales in the numerator of the combined receipts fact violates Public Law No. 86-272 (15 USC § 381).

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 Silver King Broadcasting of N.J., Inc. is granted; and

4. The Notice of Deficiency dated November 1, 1993 is cancelled.

DATED: Troy, New York
May 9, 1996

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

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

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner