

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
MEDTRONIC, INC. : DETERMINATION
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Fiscal Years :
Ended April 30, 1979 and April 30, 1980. :

Petitioner, Medtronic, Inc., P.O. Box 1453, 3055 Old Highway 8, Minneapolis, Minnesota 55440, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended April 30, 1979 and April 30, 1980 (File No. 800306).

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on July 25, 1989 at 9:15 A.M., with all briefs filed by July 23, 1990. Petitioner appeared by Paul H. Frankel, Esq., Hollis L. Hyans, Esq., and Robert J. Cunningham, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUE

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

FINDINGS OF FACT

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

In September 1973, Medtronic established a new manufacturing operation in Puerto

Rico. The site was chosen to take advantage of the low labor and property costs and also to benefit from both Puerto Rican and United States tax advantages.

Medtronic Puerto Rico, Inc. ("MPRI"), a wholly-owned subsidiary of Medtronic, was incorporated in Minnesota in 1973. In return for the contribution of capital, patents and unpatented technology, Medtronic received all the authorized common stock of MPRI. MPRI also subsequently purchased patents from a third party.

MPRI began operations in Villalba, Puerto Rico in 1974. It qualified for favorable tax treatment under former section 931 of the Internal Revenue Code, and received a 25-year tax exemption under Puerto Rican law. It had approximately 92 employees during fiscal year 1979 and approximately 126 employees during fiscal year 1980.

An artificial electronic pacemaker consists of an implantable pulse generator ("IPG") and one or two leads. The IPG produces electrical impulses which discharge at regular intervals to stimulate the patient's heart. The IPG is usually implanted in the muscles of the patient's upper right chest and leads are necessary to carry the electrical impulses to and/or from the heart. MPRI manufactures leads at its plant in Villalba while Med Rel, Inc. manufactures IPGs in Humacao, Puerto Rico.

During the years in issue, MPRI's recruiting and salary administration was done by MPRI's personnel department. MPRI's financial organization performed production accounting and general accounting, and produced monthly reports. It was audited by a local certified public accounting firm in Puerto Rico and used local counsel in Puerto Rico. It owned complete and undivided interest in the patents applicable to its products, procured its own raw materials, had its own quality assurance staff and had a general manager and assistant general managers (although it was never disclosed to whom they were responsible). It trained and certified its own employees.

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

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

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

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

Med Rel purchased certain of its raw materials from third-party vendors, which were routed through Medtronic at a price of cost plus a five to ten percent markup for handling charges. The major components of the IPGs manufactured by Med Rel were purchased from divisions of Medtronic. Batteries were purchased from the Energy Technology Division, which had originally acquired its patents and technical knowledge from an unrelated company. The price charged by the Energy Technology Division to Med Rel for batteries was based on the price for which batteries had previously been purchased from this unrelated third party. Hybrid circuitry for Med Rel was purchased from the Micro Rel Division of Medtronic. Prices for the hybrid circuitry had originally been set by the former minority ownership of Micro Rel, who

had been compensated in part on the financial performance of Micro Rel.

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

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

The Internal Revenue Service audited Medtronic for the years in issue. An international examiner was included as part of the audit team, but the nature and scope of his activities were not disclosed in the record. The Internal Revenue Service Form 4549, Income Tax Examination Changes, indicated that the income of Medtronic was adjusted for the years ended April 30, 1979 and April 30, 1980 in the area of "amortization of customer base". Said amortization was increased to \$90,774.00 for the year ended April 30, 1979 and \$268,727.00 for the year ended April 30, 1980. However, the form submitted in evidence was not executed on behalf of Medtronic. Director of Tax for Medtronic, Donald Kizershot, was vague with regard to his memory of the audit and did not recall specifics of the examination of pricing. He could only assume it was looked at. He also did not recall if there was an examination of intangibles and therefore any impact on pricing.

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

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

The Territorial Clause of the United States Constitution (Article IV, § 3, cl 3) gives Congress plenary power over all matters pertaining to Puerto Rico and other United States possessions. Under the authority of the Territorial Clause, Congress enacted a comprehensive

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

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

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

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

Several members of the boards of directors of both Puerto Rican subsidiary corporations

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

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

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

business did not exist between Medtronic and MPRI and Med Rel.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner contends that a combined report is not required pursuant to Tax Law § 211.4 in order to properly reflect its New York income for the years in issue. Petitioner further contends that Medtronic, Med Rel and MPRI do not have a unitary relationship and that Medtronic's separate reports for the years in issue fairly reflected its New York income. This last contention is purportedly substantiated by the fact that all transactions between Medtronic and the two Puerto Rican subsidiaries in issue were at arm's length. Finally, Medtronic contends that forcing a combination between itself and the Puerto Rican subsidiaries would deny it equal protection of the law and fair treatment.

On the other hand, the Division of Taxation contends that the unity of stock ownership and the substantial intercorporate transactions between Medtronic and the Puerto Rican subsidiaries are sufficient to require Medtronic to file on a combined basis. It also contends that petitioner and its Puerto Rican subsidiaries were in the unitary business of manufacturing and selling heart pacemakers during the years at issue.

CONCLUSIONS OF LAW

A. Tax Law § 211.4 provides, in part, as follows:

"In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all of the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control 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 and setting forth such information as the tax commission may require; ...provided, further, that no combined report covering any corporation not a taxpayer shall be required unless the tax commission 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."

B. The regulations in effect during the years in issue, 1979 and 1980, were those promulgated by the former New York State Tax Commission on August 31, 1976 which apply to taxable years beginning on or after January 1, 1976. Arguments by the parties based upon

other regulations are not addressed herein, although it is believed the arguments are resolved by the analysis which follows.

The regulation at 20 NYCRR former 6-2.1(a) provides, in part, as follows:

"The reporting requirements of article 9-A contemplate that each corporation is a separate taxable entity and shall file its own report. However, the Tax Commission, in its discretion, may require a group of corporations to file a combined report or may grant permission to a group of corporations to file a combined report where the requirements of stock ownership or control are met. In addition, in deciding whether it will require or permit combined reporting, the Tax Commission will consider whether the group of corporations is engaged in a unitary business and whether there are substantial intercorporate transactions among the corporations."

Hence, the regulation established the threshold requirements for requiring combined reporting pursuant to Tax Law § 211.4 as unity of ownership, engagement in a unitary business and substantial intercorporate transactions.

The regulation at 20 NYCRR former 6-2.2 expounds upon the initial requirement that there be unity of ownership, i.e., that the taxpayer own or control directly or indirectly substantially all the capital stock of the other corporations which are to be included in a combined report. "Substantially all" was defined in 20 NYCRR former 6-2.2(b) as 80 percent or more of the voting stock.

Once a determination of unity of ownership is made, the regulation at 20 NYCRR former 6-2.3(a) requires an exercise of discretion by the Tax Commission with regard to the permission or requirement for combined reporting based upon whether the corporations were in substance parts of a unitary business conducted by the entire group of corporations and whether there were substantial intercorporate transactions among the corporations. With regard to the requirement that the corporations be parts of a unitary business, the regulation states that the Tax Commission:

"will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

(1) manufacturing or acquiring goods or property for other corporations in the group; or

(2) selling goods acquired from other corporations in the group; or

(3) financing sales of other corporations of the group.

The Tax Commission will consider a corporation to be part of a unitary business if it is engaged in the same or related lines of business as the other corporations in the group, such as:

(4) manufacturing similar products; or

(5) performing similar services; or

(6) performing services for the same customers." (20 NYCRR former 6-2.3[b].)

The regulation also sets forth guidelines for determining substantial intercorporate transactions as follows:

"In determining whether the substantial intercorporate transaction requirement is met, the Tax Commission will consider only transactions directly connected with the business conducted by the taxpayer, such as described in paragraph (1), (2) or (3) of subdivision (b) of this section. Service functions, such as accounting, legal, and personnel will not be considered. The substantial intercorporate transaction requirement may be met where as little as fifty percent (50%) of a corporation's receipts are from any qualified activities. It is not necessary that there be substantial intercorporate transactions between any one member with every other member of the group. It is, however, essential that there be substantial intercorporate transactions among all members of the combined group." (20 NYCRR 6-2.3[c].)

Foreign corporations such as the Puerto Rican subsidiaries involved in the instant action were addressed in the regulation at 20 NYCRR former 6-2.5 wherein it was stated that:

"[a] foreign corporation not subject to tax will not be required to be included in a combined report unless the requirement described in section 6-2.2 of this Subpart has been met and the Tax Commission determines that the inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:

(1) intercorporate transactions; or

(2) some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected."

C. Hence, upon completion of the field audit of Medtronic, Inc. on June 9, 1982, the auditor only had Tax Law § 211.4 and the regulations as set forth in Conclusion of Law "B" to rely upon in making his determination as to whether or not Medtronic should be combined with its Puerto Rican subsidiaries, MPRI and Med Rel, in order to properly reflect Medtronic's tax liability under Article 9-A.

Consistent with the statutes, regulations and case law, once such a determination was made by the Division of Taxation, Medtronic did not have an opportunity to affirmatively show that its tax liability was properly reflected in the separate reports it filed for the years in issue.

In Wurlitzer Co. v. State Tax Commn., (35 NY2d 100, 358 NYS2d 762), the Court of Appeals explicitly said that where the Tax Commission requires combined reporting pursuant to Tax Law § 211.4, "it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected" (Id., 358 NYS2d at 766). This was in 1974.

It was not until 1983 that the Appellate Division in Matter of Coleco Industries, Inc. v. State Tax Commn. (92 AD2d 1008, 461 NYS2d 462, affd 59 NY2d 994) expanded upon the 1976 regulations, which were presumably consistent with the Wurlitzer case.¹ In Coleco, the Commission denied permission for Coleco to file a combined tax return with Coleco North, one of its wholly-owned subsidiaries. The court found this to be arbitrary and capricious. The Commission based its determination on the five factors set forth in the applicable regulations, namely:

"(1) whether the corporations are engaged in the same or related lines of business;

(2) whether any of the corporations are in substance merely departments of a unitary business conducted by the entire group;

(3) whether the products of any of the corporations are sold to or used by any of the other corporations;

(4) whether any of the corporations perform services for, or lend money to, or otherwise finance or assist in the operations of any of the other corporations; and

(5) whether there are substantial intercompany transactions among the constituent corporations." (Id., 461 NYS2d at 463.)

To the Commission, the key missing element was that there were no direct sales of products between the two corporations nor any other substantial intercompany transactions

¹The years in issue in Coleco were 1973 and 1974 and the regulations pertaining thereto, as pointed out by the court, were those in 20 NYCRR former 5.28(b) (effective 3/14/62), the predecessor to the combination regulations set forth in Conclusion of Law "B" above.

directly between them. The court found this to be a "formalistic distinction" and ignored the underlying purpose behind the combined reporting section, i.e., that the presence or absence of no single factor is decisive in determining whether combined reporting is mandatory.

"Ultimately, the 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." (Id., citing Matter of Wurlitzer Co. v. State Tax Commn., 42 AD2d 247, 250, 346 NYS2d 471, affd 35 NY2d 100, 358 NY2d 762.)

In Wurlitzer Co. v. State Tax Commn. (supra), decided by the Court of Appeals in 1974, the court highlighted the distinction between subdivisions four and five of Tax Law § 211 as follows:

"Subdivision four of section 211 of the Tax Law expressly empowers the tax commission to require a combined report because of intercompany transactions, or certain conditions are found to exist. The use in subdivision four of the word 'or' with reference to subdivision five, 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 four, 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." (Id., 358 NYS2d at 766.

In Matter of Campbell Sales Co. v. New York State Tax Commn. (68 NY2d 617, 505 NYS2d 54), the Court of Appeals restated its position in much the same language as that cited above in Wurlitzer, as follows:

"Nevertheless, as we made clear in Matter of Wurlitzer v. State Tax Commission (supra) [citation omitted] 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."

Even more recently, in Standard Manufacturing Co., Inc. v. Tax Commission of the State of New York (114 AD2d 138, 498 NYS2d 724, affd 69 NY2d 635, 511 NYS2d 229, appeal dismissed 481 US 1044), the Appellate Division restated its position that the ultimate question to be answered in these types of cases is:

"whether, under all of the circumstances of the intercompany relationship in this case, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income." (Id., 498 NYS2d at 726.)

D. Having reviewed the applicable statute, regulations and case law, what follows is an

analysis of the application of said statute, regulations and case law to the instant matter. Every domestic or foreign corporation annually pays a franchise tax upon the basis of its entire net income for the privilege of doing business in this State (Tax Law § 209[1]). Whether a taxpayer is permitted or required to file on a combined basis with other corporations is determined after considering all of the circumstances of the intercompany relationships, whether combined reporting fulfills the statutory purpose of avoiding distortion of, and more realistically portraying, true income (Matter of Coleco Indus., Inc. v. State Tax Commn., supra).

"The then applicable regulations under the section provide that the tax commission may require a combined report if the statutory requirement of ownership or control is met, the companies are engaged in a unitary business and there are substantial intercorporate transactions (20 NYCRR 6-2.1 [effective January 1, 1976])." (Standard Manufacturing Co. v. Tax Commission of the State of New York, supra, 498 NYS2d at 726.)

Medtronic does not challenge the ownership or control issue or that there were substantial intercorporate transactions in excess of 50 percent of the corporations' receipts from qualified activities. Medtronic does take issue with the Division's determination that it was engaged in a unitary business with the two Puerto Rican subsidiaries, MPRI and Med Rel.

The Division determined that intercompany transactions between Medtronic and its subsidiaries were significant enough to require combined reporting and that the subsidiaries were 100 percent owned by Medtronic. Generally, this determination, found in the audit report, is in compliance with the then applicable regulation defining a unitary business at 20 NYCRR former 6-2.3(b), and there is no question that Medtronic falls within this unitary business definition.

"As a general principle, a state may not tax value earned outside its borders" (Asarco, Inc. v. Idaho State Tax Commn., 458 US 307, 315). Further, it has long been accepted that the entire unitary income of a corporation, or of a group of unitary domestic corporations, even if generated by interstate as well as intrastate activities, may be fairly apportioned to a given state for tax purposes (Exxon Corp. v. Wisconsin Dept. of Revenue, 447 US 207, 219). The Supreme Court has also said that the "linchpin of apportionability" for State income taxation of an interstate enterprise is the unitary business principle (Asarco, Inc. v. Idaho State Tax

Commn., supra at 315). The Supreme Court, citing Mobil Oil Corp. v. Commr. of Taxes (445 US 425, 440), indicates that the proper inquiry when looking into whether or not corporations are involved or engaged in a unitary business is the "underlying unity or diversity of business enterprise, not whether the nondomiciliary parent derives some economic benefit -- as it virtually always will -- from its ownership of stock in another corporation." The court in F.W. Woolworth Co. v. Taxation and Revenue Department (458 US 354, reh denied 459 US 961) stated, very succinctly, as follows:

"In Mobil we emphasized, as relevant to the right of a State to tax dividends from foreign subsidiaries, the question whether 'contributions to income (of the subsidiaries) result(ed) from functional integration, centralization of management, and economies of scale.' [Citation omitted.] If such 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a state can gain a justification for its tax consideration of value that has no other connection with that state." (Id. at 364.)

Petitioner herein argues that there is little functional integration between itself and its Puerto Rico subsidiaries. It contends that the subsidiaries have their own accounting departments, outside counsel, training programs for employees, and that in every way both Med Rel and MPRI conducted their own fully self-contained businesses. Each company maintained its own personnel department which was responsible for recruiting and salary administration. Each had its own accounting departments and each subsidiary was responsible for the procurement of its own raw materials. Materials purchased from the parent carried a surcharge and sales of their finished goods to the parent were purportedly at market price. Petitioner does concede that MPRI and Med Rel sold substantially all of their products to Medtronic, but contends that they were arm's-length sales and that the fact of substantial sales to Medtronic alone is insufficient to establish functional integration.

However, petitioner failed to emphasize or adequately explain the Medtronic family of companies and the relationships between each and the interdependence between them (the IPG was almost always sold with the lead). In fact, Med Rel and MPRI were only created as a response to Medtronic's perceived need for additional manufacturing facilities and, in Medtronic's search for new facilities, Puerto Rico was only one of the locations considered for

that purpose. It was the lower labor costs in Puerto Rico, along with the lower costs of owning and renting property and favorable tax consequences, which provided the motivation for the decision to establish the manufacturing facilities in Puerto Rico. During the years in issue, Medtronic declared on its Federal income tax returns that it was in the business of manufacturing and selling medical equipment. Therefore, the establishment of additional manufacturing facilities does not lend credence to the argument that the Puerto Rican subsidiary companies maintained complete segregation and functioned independently of Medtronic.

Such a position is untenable in light of the facts presented in this case. Medtronic pacemakers are comprised of two primary component parts: an implantable pulse generator (IPG) and a lead. The parts are essentially interdependent, i.e., the sale of a pacemaker unit will include both the IPG and the lead. During the period in issue, Medtronic purchased substantially all of the products produced by each of the subsidiary corporations. Any product not purchased by Medtronic was purchased by related corporations. The majority of raw materials required by the subsidiaries were purchased directly by Medtronic and sold to Med Rel and MPRI with a markup. Furthermore, Med Rel purchased essential component parts manufactured by divisions of Medtronic, such as the batteries for the IPGs and hybrid circuitry.

Additionally, product research and development was performed by Medtronic employees and an allocated portion of the costs was directed to each of the subsidiaries. Neither of the Puerto Rican subsidiaries maintained a sales or marketing staff since their products were sold directly to third parties only by Medtronic, and both relied upon marketing forecasts created by Medtronic as a basis for quantity of production.

In response to questions from the administrative law judge at hearing, Mr. Donald Kizershot, Director of Tax for Medtronic, could not recall the composition of the board of directors of either of the Puerto Rican subsidiaries; nowhere in the record were the officers of these corporations stated with certainty.

In fact, the New York State Court of Appeals in Campbell Sales Co. v. New York State Tax Commn. (supra) could have been speaking about petitioner herein when it stated that:

"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 overall enterprise."

Although petitioner makes much of the independent accounting and personnel functions and the use of outside accountants and legal counsel, these do not constitute functional integration when looking into the requirement of unitary business. The circumstances herein clearly demonstrate functional integration and a symbiotic relationship between interdependent companies. Medtronic and its subsidiaries were engaged in a unitary business.

E. Having found that the Division of Taxation properly determined that Medtronic and its Puerto Rican subsidiaries were engaged in a unitary business within both the constitutional and applicable regulatory framework, it is deemed that its determination was rational. The ultimate question of whether, under all the circumstances of the intercompany relationship in this case, combined reporting fulfills the statutory purpose of avoiding distortion of, and more realistically portraying, true income can now be addressed. In answering this question, no single factor is decisive (Matter of Coleco Industries, Inc. v. State Tax Commn., supra). In view of the substantial extent and nature of the intercorporate transactions between Medtronic and its two Puerto Rican subsidiaries, it is concluded that combined reporting would result in a more realistic portrayal of true income and avoid distortion.

Medtronic's trump card with regard to the issue of distortion is the income tax examination changes (Form 4545) submitted in evidence as its Exhibit "2" indicating no adjustments to income other than amortization of customer base for the years in issue. Medtronic opines that, because no pricing adjustments were made, intercompany pricing must have been examined and analyzed by the Internal Revenue Service and a determination made that pricing between Medtronic and all of its subsidiaries was at arm's length and that, therefore, the separate reports filed by each of the companies more realistically portrays their respective true income. However, when the evidence presented in this case is closely scrutinized, no such demonstration has been made. The income tax examination changes provided by Medtronic are contained on a form executed by the examiner on April 16, 1982. However, there is no consent

to said assessment by Medtronic and no final report was entered into evidence. Mr. Donald Kizershot, Director of Tax for Medtronic, was very vague with regard to his memory of the audit and could not remember whether or not intercompany pricing was specifically examined by the Internal Revenue Service's audit team. He could only assume that such pricing was examined. Mr. Kizershot also did not remember whether or not there was an evaluation of intangibles and whether it impacted on pricing.

Even assuming that the pricing was found to be arm's length by the Internal Revenue Service, no one factor is determinative of the combination issue. (Coleco Indus. v. State Tax Commn., supra.)

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

Additionally, the testimony of John Cronin, Esq. was conclusory in nature, lacked a cogent analysis and was of little value in clarifying and analyzing the issues presented. In light of the functional integration which has been found to exist among the Medtronic group, specifically Medtronic's own perception of the Puerto Rican subsidiaries as manufacturing arms of the group, the substantial intercompany transactions and the unity of ownership, a combined report is necessary in order to properly reflect the tax liability herein. The ministerial functions pointed to by petitioner as evidence of independent corporations were merely duties performed out of expedience due to the location of the Puerto Rican subsidiaries in relationship to the corporate headquarters in Minnesota. But this alone does not establish that the corporations operated with any significant degree of independence from Medtronic.

With regard to the former State Tax Commission's decision in Digital Equipment Corporation (State Tax Commn., June 28, 1985), it is noted that therein the hearing officer was able to make detailed findings of fact with regard to the Internal Revenue Service audit and pricing adjustments for the fiscal years in issue. In fact, there was an in-depth finding of fact with regard to what transpired during the audit and the various methodologies applied by the Service with regard to intercompany purchases and the dialogue which took place between the Service and Digital during the audit period. Those critical findings were absent from the instant matter to the point where no specific conclusions could be drawn from the audit performed by the Internal Revenue Service herein. There was no direct testimony with regard to the audit and petitioner did not even submit the actual final income tax examination changes (Form 4549). However, it is also noted that the other facts in Digital distinguish it from the case at hand. The Puerto Rican subsidiary in Digital purchased approximately 19 percent of its supplies from Digital and the remainder of its raw materials from vendors in Puerto Rico, the United States, Europe and the Far East. The Puerto Rican subsidiary determined the kind and amount of materials it procured and the inventory levels and product mix it maintained. Although 94 percent of the Puerto Rican subsidiary's product was sold to the parent, Digital, it directly competed with other subsidiaries for the option to manufacture the same products. The issue of functional integration was never mentioned by the Commission in its Digital decision, nor was a finding made that there was specific unity of ownership, engagement in a unitary business and substantial intercorporate transactions such that, because of these elements, a combined report was necessary to properly reflect the tax liability. Instead, it is asserted herein that those factors mandate combination in the instant action due to the overwhelming factual findings indicating functional integration.

Finally, as stated by the court in Campbell Sales Co., Inc. (supra), it is incumbent upon the petitioner to establish that the allocation formula utilized by the Commission does not properly reflect the business it transacts in New York (citing Matter of Eastman Kodak Co. v. State Tax Commn., 33 AD2d 298, 303, 307 NYS2d 69, affd 30 NY2d 558, 330 NYS2d 617).

Just as in Campbell Sales, that burden has not been met herein.

F. The petition of Medtronic, Inc. is denied and the two notices of deficiency dated August 13, 1982 are sustained, together with such additional interest as may be lawfully owing.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE