STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

HALLMARK MARKETING CORPORATION :

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1999. : :

DETERMINATION
DTA NO. 819956

Petitioner, Hallmark Marketing Corporation, Tax Department #330, P.O. Box 419480, Kansas City, Missouri 64141-6480, 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 year 1999.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on February 15, 16, 17, 18 and April 4, 2005 at 9:15 A.M., with all briefs submitted by July 29, 2005, which date began the six-month period for the issuance of this determination. Petitioner appeared by Morrison & Foerster LLP (Paul H. Frankel, Esq., and Irwin M. Slomka, Esq., of counsel). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Clifford M. Peterson, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly required petitioner to file its corporation franchise tax report for the year 1999 on a combined basis with its parent, Hallmark Cards, Inc.

II. Whether petitioner has established reasonable cause and that it acted in good faith for the abatement of penalty asserted by the Division of Taxation pursuant to Tax Law § 1085(k).

FINDINGS OF FACT

Prior to the hearing, the parties entered into a Stipulation of Facts which contained 33 separately numbered paragraphs. Paragraphs 6, 7, and 14 through 33 note the attachment of exhibits which the parties collected and reviewed prior to hearing. In the event petitioner is forced to file its 1999 franchise tax report on a combined basis with Hallmark Cards, Inc. ("Cards"), paragraphs 10 through 13 set forth the add-back for state and local income taxes, the "rent everywhere" factor, the "wages everywhere" factor and the "receipts everywhere" factor. The stipulated facts in paragraphs 1 through 5, 8 and 9 have been incorporated into the facts below.

1. Petitioner, Hallmark Marketing Corporation ("Marketing"), was a Delaware corporation headquartered in Kansas City, Missouri. Marketing was created as a wholly-owned subsidiary of Hallmark Cards, Inc. ("Cards") in 1963 and assumed principal sales functions for Cards at some point prior to the year in issue. Neither Cards nor Marketing was a publicly held corporation.

Rod Sturgeon, a Hallmark employee since 1974, senior vice president of the personal expressions group finance organization for Cards and vice president and director of Marketing, was the chief fact witness called to testify at hearing.

2. During the year 1999 (the "audit period"), petitioner solicited, both in New York and throughout the United States, sales of greeting cards and other "social expression" products manufactured by or on behalf of its parent corporation, Cards, pursuant to a Sales and Distribution Agreement, dated September 30, 1991, and amended January 1, 1997 and January 1, 1999. The agreement provided that petitioner would be the exclusive distributor of Hallmark and Ambassador products in the United States. In addition, petitioner manufactured display

fixtures used by retailers in the sale of the social expression products. Products were sold to retailers such as card and card specialty shops, grocery stores and department stores like Walmart, K-Mart and Target.

3. Following an audit by the Division of Taxation (the "Division") of petitioner's Article 9-A return, the Division adjusted petitioner's tax liability for the year 1999 by combining petitioner with Cards, and it issued a Notice of Deficiency, assessment number L-023521025-2, dated February 13, 2004. The notice asserted an additional liability for corporation franchise tax and for the Metropolitan Commuter Transportation District ("MCTD") surcharge, in the amount of $1,109,091.00, together with interest in the amount of $359,544.99 and a penalty for substantial understatement of tax liability pursuant to Tax Law § 1085(k) in the amount of $110,908.00, for a total amount due of $1,579,543.99.

4. The Division began its audit of petitioner in September 2001, spending four days in Kansas City in July of 2002 examining documents and meeting with employees. In September 2002, in response to a request for further transfer pricing documentation, petitioner sent the Division a copy of a report by KPMG which evaluated the transactions between Cards and petitioner. However, the report was not considered by the Division until December 10, 2003, when the auditor requested that higher level audit personnel review it. By December 12, 2003, the Division reached the conclusion that the report was "weak." In all, the auditor's log, recorded on Division form 220.5, indicated 28 entries prior to the issuance of the Notice of Deficiency, 10 of which involved meetings or conversations with petitioner, 3 of which concerned requests for information and documentation and 5 of which noted analysis of information. Entries in the log were punctuated with long periods of unexplained inactivity, culminating with numerous requests for additional information and documentation in December

2003 and January 2004, including a six-page letter, dated January 2, 2004, seeking documentation, correspondence and supporting workpapers for the 2000 KPMG transfer pricing study.

5. Although petitioner had executed a consent to extend the period of limitation for assessment of franchise tax in June of 2003 permitting the Division to issue an assessment at any time prior to February 15, 2004, it would not agree to further extensions proposed in December 2003 and January 2004. Citing a lack of documentation upon which to decide the combination issue, the Division utilized the information it had collected over 29 months and issued its notice on February 13, 2004.

6. During the period in issue, Cards developed, designed and marketed social expression products, mostly greeting cards, which it marketed pursuant to the provisions of the aforementioned Sales and Distribution Agreement. The agreement provided that Marketing had the exclusive right to distribute its Hallmark and Ambassador branded products and other products in the United States, although Marketing was not prohibited from selling or distributing products produced by third parties. The 1991 agreement called for Marketing to pay Cards 84% of the suggested wholesale price of the merchandise purchased for resale, net of discounts, allowances and returns, where wholesale price meant 50% of the retail price of the products. Non-resale products were sold to Marketing at wholesale less discounts and allowances. Title and risk of loss of the products passed from Cards to Marketing upon the carrier’s arrival at the destination point, in this case the retailer, obviating the need for Marketing to maintain inventory or warehouses of its own or to incur delivery costs.

7. The 1991 agreement was subject to termination by either party on 90 days written notice, but not before September 30, 1992, and Marketing was prohibited from assigning any of its rights under the agreement without the prior written consent of Cards.

8. Pursuant to the agreement, Marketing agreed to use its reasonable efforts to promote the sale of Cards' products as widely as possible and to enhance the reputation and image of the Hallmark and Ambassador brand names. In addition, Marketing agreed to use the trademarks, copyrights and trade names belonging to Cards for the sole benefit of Cards.

The price paid by Marketing to Cards for products to be sold to retailers for resale was modified by an amendment to the1991 Sales and Distribution Agreement on January 1, 1997 to reflect a price equal to 80.5% of suggested wholesale price net of discounts, returns and allowances. The second amendment, executed on January 1, 1999, provided that Marketing would pay Cards 79.8% of the suggested wholesale price for products.

9. Cards also had distributor agreements with several companies for the exclusive right to import, sell and distribute Hallmark products in international markets. Products sold to the international distributors were F.O.B. the source, either Cards' manufacturing facility or a subcontractor's facility, and the price was wholesale less a negotiated discount. International distributors agreed to notify Cards of any copyright or trademark infringement and assist in taking action, including legal action, to stop the unauthorized use. Additionally, distributors acknowledged that all trademarks, copyrights and trade names were the exclusive property of Cards and that they would not acquire any rights or title in them by virtue of the distribution agreement or their use of the trademarks, copyrights or trade names and that the use of same inured to the benefit of Cards alone. Cards also agreed to provide the international distributors certain management services including:

a) marketing and merchandising advice, including its "system-matic" display and reorder merchandising system;

b) advice on pricing of products purchased under the terms of the agreement;

c) instruction on inventory control and other technical assistance;

d) training of the distributor's personnel at Cards' office;

e) supplying blueprints and samples of display fixtures, dividers, stock files, and related display items and assisting in locating display fixtures;

f) instruction regarding the use of the Hallmark and Ambassador trademarks on interior and exterior store signage; and

g) advice concerning the advertising and promotion of the Hallmark and Ambassador brands.

Distributor agreements with Gulf Greetings, dated April 26, 1995, Rakah Corporation, dated September 25, 1995, and Keaton International and Kids Kingdom, Inc., dated March 10, 1999, contained almost identical terms and were representative of the independent agreements Cards had with other distributors.

10. On October 1, 1991, Cards and Marketing entered into a Trademark License Agreement by which Cards granted Marketing a royalty-free, nonexclusive license to use, in the United States, the Hallmark and Hallmark Cards trademarks and trade names, alone and in combination with the "Coronet" design (the "licensed marks"), in connection with the manufacture of products by Marketing or its vendors, and the promotion, marketing, advertising, distribution and sale of Hallmark branded products. In addition, Cards granted Marketing a royalty-free, nonexclusive license to use the trademark and trade name Hallmark as part of the

trade name of social expression shops in the United States and to sublicense its rights to the owners of said shops.

11. Marketing conveyed to Cards all of its rights in any goodwill or other interest which arose as a result of its use of the licensed marks and agreed to maintain the standards of quality established by Cards for the use of the trademarks and trade names. In addition, Marketing was charged with performing trademark enforcement and quality control services, ensuring that the Hallmark brand was utilized in accordance with the standards developed by Cards. Marketing employees typically inspected signage, merchandising and color schemes in retail outlets in their efforts to assure that standards were being met. Marketing had the right to take legal action to prohibit unauthorized or unlicensed use of a licensed mark. As indicated above, Cards included similar provisions in its agreements with international distributors.

12. According to the 1991 Sales and Distribution Agreement, Marketing sold its products through a mass merchandise channel and the specialty/retail channel. The mass channel included "Expressions from Hallmark/Ambassador" stores and Walmart. The specialty channel included the retail Hallmark outlets, most of which were owned by independent third parties. Marketing sold to thousands of retail outlets.

13. In 1999, Marketing utilized five channels, which included the mass retail channel, card shops, corporate card shops, specialty stores and mass merchandise retailers. The mass retail channel was comprised of grocery stores, chain drug stores and department stores. The card shop channel included independently owned Gold Crown retailers. The corporate card shops consisted of Specialty Retail Group stores. The specialty stores channel included bookstores, pharmacies and gift shops. The mass merchandise retailers included Walmart and K-Mart.

14. The mass channel consisted of both the mass retailers and the mass merchandisers. The mass retailers alone accounted for 76% of the retail outlets selling Cards' products in the United States, while the mass merchandise retailers constituted 8% of the outlets selling Cards' products in the United States.

15. Independent Gold Crown retailers constituted 9% of the retail outlets selling Cards' products. Gold Crown retailers were required to meet certain standards developed by Cards, such as purchasing a certain amount of overall stock from Marketing and primarily selling only Hallmark brand cards and products. In exchange, Gold Crown retailers were entitled to use the "Hallmark Gold Crown" on their storefronts.

16. In addition to the independents, Hallmark Specialty Retail Group, Inc. ("SRG"), a wholly-owned subsidiary of Marketing, operated about 350 Gold Crown stores, which represented about 1% of the retail outlets selling Cards' products in the United States. SRG operated these stores to establish stores in markets which were not large enough to support a Gold Crown store or to maintain stores after the owner left the business or passed away without a successor in place. Marketing's sales to SRG were on the same terms as its sales to unrelated Gold Crown retailers. Also, SRG test-marketed products and evaluated the viability of new retail concepts prior to general market implementation.

17. Independent specialty stores constituted 6% of the retail outlets selling Cards' products in the United States and included bookstores, individually owned pharmacies and gift shops which neither displayed the Hallmark name on their storefronts nor primarily sold Hallmark brand products.

18. In 1999, Marketing employed about 1,500 people who helped carry out the functions of sales, collections and retailer service. Depending on the distribution channel, Marketing

performed various services for retailers including submitting product orders to Cards on their behalf; providing training on the display of social expression products; packing, unpacking, and stocking products; and advising on store layout and space usage for its mass channel customers. In addition, Marketing also provided real estate services to Gold Crown retailers and other independent specialty stores, including store site selection and lease negotiation. The costs involved in providing stores with real estate-related advice was relatively minimal, only amounting to $2.3 million in 1996, $2.7 million in 1997, $3 million in 1998 and $3.6 million in 1999. Overall operating expenses for the period 1996 through 1998 were $364 million. Cards research developed and maintained the demographic modeling tools used in determining store locations.

Some job titles listed in the Hallmark Employee Identification System referenced locations in foreign countries. However, Vernon Clements, Operating Tax Manager for Cards, explained that these jobs were associated with Marketing only because it was the sole entity that could process the withholding taxes and file tax returns in all 50 states. In addition, Mr. Clements explained that once a title was listed in the system it could not be removed regardless of whether it was filled or not. Hence, the Employee Identification System was not a reliable list of current employees of Marketing.

19. Marketing assisted in the development of a software system called the retail operating model ("ROM") which was used to assist independent retailers with inventory control, performance reporting, e-mail and warehousing. Primarily, the ROM software was marketed to specialty retailers such as Gold Crown retailers who owned ten or more stores to help manage their complex businesses. Marketing and Cards shared the costs for the ROM software development, but the majority of the costs was subsequently borne by retailers.

20. Marketing did not advertise directly to consumers but did engage in a small amount of advertising to retailers in trade magazines and at retail trade shows. Its advertising expenses for 1999 were about $600,000.00. During 1999, Marketing produced catalogs which were sent directly to consumers of Gold Crown retailers, as a means of increasing sales at those stores. The cost of this catalog program was partially paid by the retailers. In addition, the retailers identified consumers who wished to join the Hallmark Keepsake Collector's Club. For a fee, these consumers were entitled to annual ornaments and advance notification of new products. The Cards advertising department decided what information would be imparted to these special consumers. Marketing helped facilitate the program at an unspecified level and at unspecified expense.

21. To facilitate distribution of product, Marketing both manufactured and purchased from third-party contract manufacturers (for which it had oversight responsibility) display fixtures for use in the retail stores and outlets to which it sold products, since fixtures were not generally available from third-party manufacturers. Marketing manufactured about 90% of the fixtures for use in the retail stores. Fixtures were loaned to the mass channel customers and sold to the specialty channel stores. The fixtures were delivered to store and outlet locations and then installed.

22. Fixtures were an important part of the marketing of Cards' products because they enhanced the products' appeal. Many of the fixtures were lighted. The design of the fixtures was considered important and the conceptual design was created by Cards as a part of product development, since the fixture's design was dependent on the products to be displayed.

23. Following the design of the fixture by Cards, Marketing created the manufacturing specifications, with special attention to any individual needs of the retailer to whom the fixture was being delivered.

24. The materials for the manufacture of the fixtures were purchased from Cards pursuant to a Fixture Materials Agreement, dated January 1, 1996. Pursuant to the agreement, Marketing purchased the fixture raw materials at 5% of Cards' cost. However, Marketing's fixture manufacturing division operated at a loss, presumably as a service to promote Cards' merchandising and advertising efforts. The operating expenses attributable to fixture manufacturing were less than 5% of Marketing's total operating expenses. For 1999, fixture manufacturing accounted for $14.9 million in expenses while total expenses were $353.6 million.

25. As part of an advertising initiative, Cards developed the "Gold Crown Program" used at Gold Crown retail stores. Consumers were encouraged to sign up for a Gold Crown card which tracked purchases and rewarded higher volume purchasers with promotions and discounts. A database of cardholders was maintained by Cards for purposes of advertising.

26. Marketing had an additional subsidiary in 1999 called Retail Plans and Management, Inc., which held notes receivable primarily related to fixtures and troubled retailer loans.

27. In May 1999, Marketing entered into a receivables agreement to sell, irrevocably and without recourse, on an ongoing basis, all of its accounts receivable to Hallmark Funding Corporation ("HFC"). HFC funded its purchase of the receivables with a subordinated note.

28. HFC was incorporated under the Companies Law of the Cayman Islands on February 1, 1999 and was a wholly-owned subsidiary of H.A., Inc., a wholly-owned subsidiary of Cards.

29. In 1999, the receivables were sold at a discount of 19.9%, a rate which approximated the cost of returns, discounts, bad debts, allowances and the time value of money. The discount was recognized as a loss in 1999 of approximately $307,000,000.00.

30. Marketing recognized approximately $13,000,000.00 in interest income from HFC for the year 1999, an amount resulting from interest on outstanding monthly balances which accrued interest at a rate of 130% of applicable Federal rates. At the end of 1999, the outstanding borrowings from Marketing totaled $405,745,101.00, on which it incurred service costs of $3,693,810.00.

31. Marketing and Cards entered into an agreement, dated January 1, 1992, which provided that each would pay the other for services rendered in areas including finance, security, risk management, personnel, tax, accounting, data processing and building and ground management, also known as general and administrative expenses. The recipient of the services was charged a sum for the administrative service to compensate the provider of the services fully for all goods and services furnished.

32. In the Notes to Audited Financial Statements for Marketing for the year 1999, it was noted that the majority of the general and administrative costs incurred were paid by Cards and charged to Marketing at actual cost. These were specific charges relating to payroll, benefits and insurance which totalled $233,000,000.00. In addition, Cards charged Marketing, at actual cost, an additional $39,900,000.00 for occupancy and other administrative overhead items in 1999.

33. Understanding the importance of arm's-length transactions between Marketing and Cards and the impact on reporting requirements for New York State corporation tax purposes, Cards sought to set an arm's-length transfer price for products sold by Cards to Marketing.

34. Originally, the transfer price established for 1999 was based upon the 1998 price. However, in October 1999 KPMG was retained by Cards to evaluate and recommend a range of transfer prices for the 1999 tax year for the related party transactions between Cards and Marketing. Arthur Anderson, another national accounting firm, was the audit firm for Cards in 1999.

35. The principal author of the transfer pricing study, "An Evaluation of Transactions between Hallmark Cards Incorporated and Hallmark Marketing Corporation: Dealing Cards at Arm's Length," dated May 2000, was Ian E. Novos, Ph.D., a senior director at KPMG whose expertise was in the area of transfer pricing. Dr. Novos was well acquainted with the transfer pricing between Cards and Marketing because he had prepared a report for the years 1992 through 1994 which was used in a prior audit of Marketing by the Division of Taxation, and which resulted in a settlement for the years 1992 through 1998. The earlier report was completed in September 1999. In October of 1999, KPMG was asked to prepare an arm's-length pricing report for 1999, which is dated May 2000. However, the results were provided to Cards in early 2000 so that it could make year-end adjustments and reflect current arm's-length prices on the 1999 returns and financials.

KPMG used the functional analysis and interviews of several key individuals in the Hallmark group of companies from the prior report in addition to supplemental information regarding changes to the operations for the intervening period (1994 - 1998) as a foundation for its May 2000 report.

36. The report discussed the business operations of Cards and Marketing as set forth in the Findings of Fact listed above and, based upon the functional analysis performed, reviewed various methods listed in the regulations promulgated pursuant to Internal Revenue Code

("IRC") § 482 for determining the best and most appropriate methodology for determining the transfer price. KPMG determined that the comparable profits method ("CPM") was best. This methodology utilized objective measures of profitability, or profit level indicators ("PLI"), from uncontrolled businesses engaging in similar activities under similar circumstances. The proper arm's-length transfer price for the controlled corporations is then determined by looking to the operating profit the "tested party" would have earned on the related-party transactions if its PLI was equivalent to those of the uncontrolled businesses. PLI's are financial ratios that measure the relationships among profits, costs incurred or resources employed. The "tested party" for the PLI is the entity for which the most reliable criteria from uncontrolled comparables can be obtained. KPMG selected Marketing to be the tested party in this matter because it was principally a distributor of products that provided routine services for which it believed there were reliable data for a good number of uncontrolled comparables.

37. KPMG looked at and rejected other transfer pricing methods set forth in Treasury Regulation § 1.482-4 before selecting the CPM, to wit: the comparable uncontrolled price method; the cost plus method; the resale price method; and the profit split method. These, together with the chosen comparable profit method, are the five methods specified in Treasury Regulation §1.482-4 for determining an arm's-length result for the transfer of tangible property between related parties like Marketing and Cards.

38. Besides the comparable profits method, only the resale price method was considered by KPMG to be a viable alternate transfer pricing method in this matter. However, reliability of the resale price method was considered less dependable where there were functional differences between the tested party and the comparables. In addition, the differences in accounting classifications of items between sales, cost of sales and operating expenses were more

problematic for the resale price method where the impact on gross profit margins was more significant than on operating profit measures used in the comparable profits method.

39. KPMG sought a set of comparable distribution companies which were functionally comparable to Marketing in order to establish an arm's-length operating margin under the CPM. With the methodology chosen, KPMG then proceeded to choose comparables for Marketing from three databases containing financial information on publicly traded United States companies: Compact Disclosure, Mergent Company Data, and Standard and Poor's Compustat PC Plus. These databases compile and use data from the Securities and Exchange Commission ("SEC"), and one, Compustat, uses additional data from publicly available annual and quarterly shareholder reports and SEC Forms 10-K and 10-Q.

40. KPMG narrowed the number of comparables by beginning its search with wholesale distributors of nondurable goods based on the Standard Industrial Classification ("SIC") codes. These codes were developed by the United States government to promote uniformity and comparability in the presentation of statistical data. Then quantitative and qualitative screens were applied to the set of companies to find the best comparables available. Quantitative screens look to financial indicators while qualitative screens are based on the subjective judgments of screeners based on detailed information of each business. Each method is geared toward finding the most appropriate comparables possible.

41. Initially, KPMG identified 207 comparable companies to which it applied "screens" to filter out undesirable companies. Aware that a smaller set of comparables could lead to distortion, KPMG developed two sets of comparable distributors: a broad set which included distributors in general and a narrow set that reflected an in-depth analysis of each business. To compile the broad list, a quantitative screen was applied to the companies in the original set

which eliminated those with an "advertising expense to total cost" ratio greater than 3%. This screen eliminated companies which spent significant resources on developing intangibles, something KPMG assumed Marketing did not do. Other quantitative screens applied to the original field of comparables were the elimination of companies with average sales under $20 million for the preceding three years and companies with less than two years of financial statement data. The $20 million cut-off was the product of a statistical test KPMG performed which indicated that $20 million was the point above which there was no significant relationship between the Berry ratio and average sales. In fact, companies with sales over $20 million had a higher median Berry ratio than those below $20 million. Therefore, there was a comfort level with those comparables. After this screening process, KPMG was left with 101 distributor comparables from which arm's-length returns for distribution companies could be discerned with a high level of confidence, unaffected by distortion from a few anomalies.

42. The smaller, narrow set of comparables was obtained by applying screens to the broad set of comparables which analyzed information on the description of the business and SEC 10-K filings. Companies were rejected for several reasons: that they were inactive; did not distribute to retailers; had retail operations; manufactured; distributed prescription drugs or chemicals; provided medical services; or were foreign corporations or earned more than 20% of revenues from foreign operations. Since the SEC 10-K filings contained detailed descriptions of a company's business operations, more judgment was required on the part of the reviewer in determining whether a company should be rejected. After this analysis, nine companies remained as the final set of comparables, all of which were determined to have a greater degree of comparability with Marketing than the others.

Dr. Novos explained that it was important that the comparables chosen provide value added services and not possess nonroutine intangibles, or intangible property considered central to the conduct of business and without which the business could not be conducted.

43. In applying the comparable profits method, KPMG had to choose a PLI which demonstrated, for Marketing as the tested party and the nine comparables, the relationship between profits and sales, costs or resources employed. It chose the Berry ratio (gross profit/operating expenses) because it is often applied to a distributor whose cost of sales consists chiefly of the cost of purchasing goods that are then resold. The ratio assumed that the distributor's operating expenses reflected the level and intensity of the reselling functions it performs, thus reflecting the return earned for performing these functions. KPMG concluded that Marketing was such a distributor of Cards' products and therefore chose to use the Berry ratio as a profit level indicator to evaluate the transfer prices Marketing paid to Cards and comparing the results to those of the comparables.

44. In determining whether Marketing's PLI was comparable to those of the comparables, KPMG utilized an interquartile range, or the range from the 25^{th} to the 75^{th} percentile of the results derived from the comparable uncontrolled companies.

45. KPMG's choice of the Berry ratio as the appropriate PLI reflected its belief that the value of the social expression products was less important than the services Marketing performed for Cards, especially given the mere momentary ownership of the products by Marketing.

46. As stated, after applying the quantitative and qualitative screens, KPMG was left with a set of nine comparables, each of which was a distributor. The nine companies and a brief description of their business activities are as follows:

a. **Advanced Marketing Services, Inc.**

Advanced Marketing was engaged in distributing and packaging general interest books to membership warehouse clubs and office product superstores and other specialty retailers, operating four distribution centers in the United States. Also, Advanced Marketing published a limited number of titles through its in-house publishing arm. The company provided product selection advice, merchandising, packaging, product development services, distribution and handling services and in-store management of certain customers' book departments through its independent service representatives. It introduced a Vendor Managed Inventory replenishment system to reduce the need to write individual location orders and to improve inventory turnover. It developed software to forecast future book sales based on the life expectancy of particular titles. The Vendor Managed Inventory replenishment system was used to prepare store level orders for Advanced Marketing's two largest customers in the latter part of 1997. In March 2000, the company had 561 full-time employees and additional unspecified part-time employees who were hired primarily during peak holiday periods.

b. **Amcon Distributing Co.**

Amcon distributed a wide variety of consumer products, including cigarettes and tobacco products, candy and other confectionery, beer, soft drinks and other beverages, groceries, natural foods and health and beauty products from seven distribution centers. Amcon also markets its own private label candy under a manufacturing agreement with a third party. It served the Great Plains and the Rocky Mountain region. Amcon offers planograms (store layout planning tools) to its convenience store customers to assist in the design of their stores and display of products within the stores and internet-based customer maintenance and reporting. Amcon maintains eight distribution centers in the United States, which included the distribution center of FFH, a health food distributor it acquired in November of 1997. Because it distributes products regulated by the government, it incurs additional costs of compliance. As of September 30, 1999, Amcon had 1,017 full-time and part-time employees.

c. **Celebrity Inc.**

Celebrity was one of the largest distributors of artificial flowers, foliage and flowering bushes, selling to mass market retailers, craft store chains, other retailers and wholesale florists. Celebrity's sales force assisted customers in devising market strategies, planograms and merchandising concepts as well as offering advice on advertising, product promotion and store displays. Celebrity offered over 14,000 products to approximately 2,000 customers both domestically and abroad and contributed to their design. Celebrity coordinated the just-in-time delivery requirements of many customers, especially the mass marketers, which needed to minimize inventory costs while assuring full product availability. To assist in this endeavor it utilized electronic data exchange for the placement of orders. As of August 31, 1999, the company had 551 full-time and part-time employees. The company works with about 70 manufacturers but purchases most of its products from only 12. Since it is the predominant customer of these suppliers, Celebrity believed it received superior pricing and service. The company competes on the basis of customer service, product quality, supply dependability, product line breadth, price and brand name recognition. Celebrity has registered many trademarks in conjunction with its products in the United States which it believed had significant value in the marketing of its products and services and protects them vigorously against infringement. The company faced significant risk from its operations in Asia, including fluctuations in trade regulation, economic instability in the Far East and currency fluctuations.

d. **Color Spot Nurseries, Inc.**

Color Spot, one of the largest wholesale nurseries in the United States, sold high quality plants to retailers and provided extensive merchandising services and sales and inventory planning to leading home centers, mass merchants and premium independent garden centers. The company provided its customers with a broad array of value-added services, such as in-store merchandising, product display and maintenance, promotional planning and product reordering, including sales and inventory planning, all of which it believed were valuable in differentiating it from its competitors. Its merchandising services also included the design and construction of display tables and end caps, as well as reordering and restocking services. The company was the owner of the trademark "COLOR SPOT" in the United States under which the majority of its products were sold. As of September 1999, the company had 2,500 full-time employees and over 4,200 employees during peak growing season, February through June.

e. **Daisytek International Corporation.**

Daisytek was a wholesale distributor of computer, copier, fax and office supplies products, professional audio and video tape products and was also a leading provider of transaction management services to both traditional and electronic commerce companies. The company operated in three business segments: computer and office supplies; professional tape products; and transaction management services. Each segment offered different products and services and was managed separately. The computer and office supplies segment distributed over 10,000 products to over 30,000 customer locations, including value-added resellers, computer supplies dealers, office product dealers, contract stationers, office product superstores and other retailers who resold to end users. Computer supplies revenues for the fiscal year ended March 31, 2000 represented 89.5% of total revenue for the period. In this segment, the company used sophisticated telemarketing, direct mail programs, innovative sales promotions, and electronic commerce technology to market its product. Daisytek's professional tape products segment was a distributor of media products to the film, entertainment and multimedia industries, distributing more than 3,000 products to over 26,000 customers. Customers included production and post production companies, educational institutions, broadcast stations and others. Revenues from this segment represented 8.8% of total revenues for the fiscal year ended March 31, 2000. The company's third segment, transaction management services, provided business infrastructure solutions for manufacturers, distributors and retailers which included order management, web-enabled customer care, billing and collection services, information management, international fulfillment and distribution services and professional consulting. Customers were able to place orders directly into Daisytek's order processing system. In addition, the company provided extensive retail training for its computer supplies products sales personnel. Daisytek operated distribution centers in the United States, Canada and Mexico. As of March 31, 2000, the company had about 1,676 full and part-time employees in the United States and abroad.

f. **Di Giorgio Corporation.**

Di Giorgio was an independent wholesale distributor of grocery, frozen and refrigerated food products that supplies about 17,300 products to more than 1,700 supermarkets (independent and chain stores). The company also sells its own line of "White Rose" products that are made by third-party manufacturers and comprise about 4% of sales. The company developed and distributed an internet product, "EasyGrocer.com," to retail supermarkets which allowed customers to order from a local supermarket's entire inventory for either delivery or pick-up. Di Giorgio maintained three large distribution centers in the New York Metropolitan area from which it serviced its customers. The company also provided retail support services, including advertising, promotional and merchandising assistance, retail operations counseling, computerized ordering, insurance, coupon redemption, store layout, equipment planning, store engineering, sanitation and security services. The company sent retail counselors to stores on a regular basis to represent the company and to advise store management regarding operations. Most customers utilize computerized order entry, which enabled them to place orders 24 hours a day, 7 days a week. Di Giorgio owned trade names and trademarks which it believed gave it a competitive advantage. Two trade names, Met and Pioneer, are owned by the company but used by independent customers. It enabled smaller retailers to gain the advantages of merchandising and advertising of much larger stores. In exchange, these customers were obligated to purchase most of their product from Di Giorgio. As of January 1999, the company employed approximately 1,275 people.

g. **Globenet International I Inc.**

In October 1999, Globenet changed its name to Royal Bodycare, Inc. The company marketed various personal care products, including herbs, vitamins and minerals, as well as natural skin, hair and body products. All the products are marketed under the Royal BodyCare trade name and are purchased from unaffiliated suppliers and manufacturers, which make or process the products in accordance with the company's specifications. The company employed about 138 employees in 1999. The company rents office and warehouse space of 119,000 square feet. The product was marketed through 132,000 independent distributors, of which 112,000 were located in the United States. These individuals used a direct marketing approach to end users, explaining the products and demonstrating their use and application. The internet was used to enhance communication with distributors about new products, specials and promotions.

h. **J B Williams Holdings, Inc.**

J B Williams was a holding company with subsidiaries which marketed, sold and distributed personal and healthcare products through a network of independent brokers to retailers. Products distributed included men's grooming products, shampoos and conditioners, pre-shave lotions, shaving soap, mouthwash, throat spray and lozenges, and cold sore and fever blister medication. Walmart accounted for 17% of the company's sales. The company's products were manufactured by outside third parties, although J B Williams held the trademarks for products such as Aqua Velva, Lectric Shave and Cepacol, among others, which it considered to be its most valuable assets. The company had 49 employees and maintained its executive offices in Glen Rock, NJ, while using public warehouses and distribution facilities in Indiana and Nevada.

i. **U S A Floral Products, Inc.**

U S A Floral Products was a wholesale distributor of perishable floral products, including freshly cut flowers, greens and potted plants and floral-related hardgoods like vases, glassware, foam for flower arranging, tools and other supplies. The company had the largest integrated distribution system of floral products in the world, with hundreds of sources of supply and more points of distribution than any of its competitors, giving it an advantage in serving mass-market retailers and significant buying power with growers and suppliers of hardgoods. The company's size also allowed it to realize savings on transportation and handling costs. In addition, it provided pre-packaged floral bouquets and arrangements to retailers. It provided marketing materials and its personnel maintained floral displays for mass market retailers and helped to prepare specific arrangements to meet customer needs. It also offered Internet-based services to its customers. Floral provided higher value-added services to customers including bouquet and arrangement making, product branding, marketing support to retailers and freshness dating. Customers included retail florists, supermarkets, mass-market retailers, catalog retailers and Internet retailers, as well as wholesale distributors and arrangement and bouquet makers. The company did not operate growing operations or retail florists. As of March 2000 the company had approximately 3,700 employees.

47. Generally, the comparable profits method must utilize the data from a three-year period of comparability, which includes the taxable year under review and the preceding two years. In the instant matter, 1999 data was not fully available for the comparables because of differing fiscal years, and KPMG was forced to rely on data from the period 1996 through 1998. However, KPMG included in its report an analysis of 1999 using Marketing's data.

48. KPMG made several specific adjustments in an attempt to improve comparability between Marketing, the tested party, and the comparable firms identified above. These adjustments addressed the differences in payment terms for sales and purchases, the differences in inventory holding and accounting for the function of manufacturing of fixtures.

49. The purchase and sale of product under delayed payment terms entails the purchase or sale price and a loan for the same amount, and a price which includes an interest charge. Firms account for this in various ways and the results may affect the level of sales revenue and cost of sales and distort profitability comparisons. KPMG made adjustments to the Berry ratios of the comparables by subtracting an adjustment factor from sales (gross profit) and cost of sales of each comparable.

50. Because Marketing held no inventory and most distributors do, it was necessary for KPMG to make an adjustment to the comparable distributor's data for inventory level differences, where the differences reflect a difference in services that the comparable offers to its

customers or takes on from its suppliers. The underlying theory was that holding inventory is costly and independent distributors providing the service required greater compensation from customers and suppliers, thus warranting an adjustment.

51. To account for the difference in inventory holding services, KPMG adjusted the gross profits of the comparables to consider the interest expense on the difference in the inventories between Marketing and the comparables.

52. Based on these two adjustments KPMG created a table of the interquartile range of the Berry ratios of the nine comparable distributors and found that for the three-year period 1996 through 1998 Marketing's Berry ratio fell within the interquartile range for two of the three years and within the range for the three-year average. The table below reflects the Berry ratios for the narrow set of comparables as adjusted for accounts receivable, accounts payable and inventory.

	1996	1997	1998	Weighted Avg. 1996-1998
25th Percentile	1.10	0.93	1.14	1.00
50th Percentile	1.25	1.12	1.16	1.16
75th Percentile	1.26	1.22	1.18	1.20
Marketing	1.11	1.09	1.09	1.10

A second table was prepared for the larger set of distributors and it was demonstrated that Marketing's Berry ratio was within the interquartile range for two of the three years and also within the average for the three-year period. The following table reflects the Berry ratios for the broader set of 101 comparables as adjusted for accounts receivable, accounts payable and inventory.

	1996	1997	1998	Weighted Avg. 1996-1998

25th Percentile	1.09	1.09	1.10	1.09
50th Percentile	1.17	1.20	1.20	1.20
75th Percentile	1.32	1.34	1.33	1.34
Marketing	1.11	1.09	1.09	1.10

53. Dr. Brian J. Cody also prepared an analysis of Marketing's intercompany pricing and the derivative analyses. Dr. Cody had 17 years of experience in government economic studies and transfer pricing while working closely with many companies in various industries. He was a senior economist with the Federal Reserve Bank of Philadelphia, a transfer pricing manager at Coopers and Lybrand and a partner in the intercompany transfer pricing group of Arthur Anderson. As of the hearing date, Dr. Cody was a vice president of InteCap, Inc., a subsidiary of Charles River Associates Inc. He used his knowledge to negotiate unilateral and multilateral advance pricing agreements and consulted on intercompany pricing structures. In addition, Dr. Cody is a published author and distinguished speaker on the subject of transfer pricing. He was accepted as an expert in transfer pricing.

54. An update was performed by Dr. Cody which utilized the 1999 financial data for Marketing and the nine comparable companies for the period corresponding to Marketing's 1999 fiscal year.[1] The following tables set forth the Berry ratios reflecting the 1999 data as prepared by Dr. Cody.

Comparable Cos.	**3 yr. Wt. Avg.**	**1999**	**1998**	**1997**
Advanced Marketing	1.395	1.427	1.406	1.318

[1]Dr. Cody used data acquired from the Compustat database which he confirmed (with Compustat) used restated financial data which insured that acquisitions, dispositions, and other material changes were captured and presented to give a consistent view of income statements and history within the company.

Amcon	1.083	1.280	0.873	1.117
Celebrity	1.011	1.069	1.147	0.838
Color Spot	0.999	1.082	1.166	0.715
Daisytek	1.254	1.047	1.401	1.417
Di Giorgio	1.797	1.971	1.683	1.715
Globenet	1.014	1.027	1.029	0.938
JB Williams	1.190	1.241	1.158	1.157
USA Floral	1.098	1.059	1.173	0.988
Statistical Analysis	3 Yr. Wt. Avg.	1999	1998	1997
Maximum	1.797	1.971	1.683	1.715
Upper Quartile	1.254	1.280	1.401	1.318
Median	1.098	1.082	1.166	1.117
Lower Quartile	1.014	1.059	1.147	0.938
Minimum	0.999	1.027	0.873	0.715
Marketing	1.103	1.130	1.088	1.091

55. As stated above, Marketing manufactured store display fixtures that were provided to customers, which presented a functional difference with many of the distributor comparables, most of which did little manufacturing. However, KPMG minimized the effect of this function, stating that operating expenses associated with fixture manufacturing were only $14.9 million per year over the period while total operating expenses for Marketing as a whole were $353.6 million and that the Berry ratio implicitly adjusted for the difference in function by recognizing a return on the manufacturing function.

KPMG separately analyzed the manufacturing function and its effect on the “Berry” ratio. The Berry ratio is often applied to a distributor whose cost of sales consists chiefly of the cost of purchasing goods that are then resold. KPMG derived a set of comparable manufacturing companies and calculated the return on assets for them, and then determined that an arm’s-length return for Marketing's manufacturing function was the median return on assets of the selected manufacturing companies. KPMG then made an adjustment to the "Berry" ratio for the nine selected comparables to assume that each of the distribution comparables engaged in manufacturing to the same extent as Marketing. KPMG determined that Marketing still fell within the interquartile range of the comparables. KPMG concluded that this adjustment demonstrated that Marketing's manufacturing activities did not affect the results of its IRC § 482 analysis, a conclusion confirmed by Dr. Brian Cody, who found that KPMG's manufacturing adjustment did not materially affect the KPMG report and its conclusions.

56. As stated in Findings of Fact "27" through "30", Marketing entered an Agreement on February 16, 1999 whereby it agreed to sell its receivables to HFC. HFC agreed to assume all bad debt and returns risks and the cost of holding the receivables until payment, two factors which justified a discount on the purchase price for the receivables. A decision was made to account for losses due to returns and allowances in the numerator, or gross profits, of the Berry ratio. This was done to accurately reflect the set off against sales in arriving at the net sales amount. The theory was that not accounting for the returns and allowances would have resulted in a higher numerator, a larger Berry ratio and a distorted placement of Marketing in the interquartile range. This was a significant consideration for KPMG because Marketing's sale of its receivables significantly reduced its 1999 average monthly receivables balance.

57. After making the adjustments for accounts receivable, accounts payable and inventory for the set of comparables using the 1996 through 1998 data, and Marketing's 1999 data, KPMG calculated the Berry ratios for each and established an interquartile range of .96 to 1.16. Marketing's Berry ratio, 1.13, was within the arm's-length range of profitability of comparable uncontrolled parties. Cards used the range to make year-end adjustments to Marketing's books,

which resulted in Marketing paying Cards 79.8% of the suggested wholesale price net of discounts, allowances and returns for products in the year 1999.

58. To determine if the Berry ratio was a reasonable PLI to utilize in applying the comparable profits methodology, Charles River Associates Inc. tested two alternative PLI's which are also used when applying the comparable profits methodology to companies like Marketing. The two profit level indicators used were the return on sales (operating profit expressed as a percentage of net sales) and the return on operating assets (operating profit expressed as a percentage of operating assets). These particular PLI's were commonly used to test the reasonableness of intercompany pricing policies between a manufacturer and its related party reseller and they were considered less sensitive to the classification of expenses as operating expenses or costs of goods sold than the Berry ratio. The return on assets was also less sensitive to functional differences between the tested party and the functionally comparable companies than other PLI's.

59. The return on sales analysis indicated that Marketing's average return on sales was within the interquartile range for the three-year period 1997 through 1999 established by the largest and smallest return on sales percentages of the comparable companies. In addition, Marketing's return on sales percentage for the year 1999 was within the interquartile range as established by the nine comparables. Below is a tabulation of that data as generated by Charles River Associates Inc.

Comparables	3 Yr. Wt. Avg.	1999	1998	1997
Adv. Marketing	3.5%	3.9%	3.6%	2.5%
Amcon Dist.	0.8	2.1	-1.2	1.4
Celebrity Inc.	0.2	1.5	3.1	-3.8

Color Spot	0.2	2.5	5.9	-10.3
Daisytek	2.4	0.6	3.4	3.1
Di Giorgio	2.0	2.3	1.6	1.9
Globenet	0.4	0.9	1.9	-4.6
JB Williams	9.2	11.2	7.8	8.4
USA Floral	2.3	1.4	4.1	-0.3
Statistical	**Analysis**			
Maximum	9.2%	11.2%	7.8%	8.4%
Upper Quartile	2.4	2.5	4.1	2.5
Median	2.0	2.1	3.4	1.4
Lower Quartile	0.4	1.4	1.9	-3.8
Minimum	-0.2	0.6	-1.2	-10.3
Marketing	1.8%	2.2%	1.5%	1.6%

60. The return on assets analysis demonstrated that Marketing's average return on assets fell within the interquartile range for the three-year period 1997 through 1999 as well as for the year 1999. The following tables reflect the outcomes of the analysis performed by Charles River Associates Inc.

Comparables	3 Yr. Wt. Avg.	1999	1998	1997
Adv. Marketing	9.7%	11.3%	9.5%	7.5%
Amcon Dist.	6.4	13.4	-9.1	10.6
Celebrity Inc.	1.7	4.5	8.3	-6.2
Color Spot	0.7	2.4	5.5	-11.6
Daisytek	9.4	3.2	13.2	14.4
Di Giorgio	9.0	11.7	7.4	7.4
Globenet	0.7	3.0	7.1	11.2
JB Williams	7.4	9.7	6.5	5.6

USA Floral	3.0	1.4	6.9	-1.3
Statistical	**Analysis**			
Maximum	9.7%	13.4%	13.2%	14.4%
Upper Quartile	9.0	11.3	8.3	7.5
Median	6.4	4.5	7.1	5.6
Lower Quartile	1.7	3.0	6.5	-6.2
Minimum	0.7	1.4	-9.1	-11.6
Marketing	3.6%	4.7%	3.0%	3.1%

61. The Division introduced Dr. Alan C. Shapiro who was accepted as an expert in transfer pricing, economics, corporate finance and the valuation of intangibles. Dr. Shapiro taught at the Wharton School, University of Pennsylvania and, from 1981 to present, at the Marshall School of Business, University of Southern California. He has written two books on multinational financial management since 2003 and several others on corporate finance. In addition, he has published numerous articles on a variety of subjects and presented executive programs at universities and corporations in areas from global macroeconomics to international financial management.

62. Dr. Shapiro analyzed the original KPMG report upon which the transfer price was established herein, in addition to the reports of Dr. Cody, and came to the conclusion that the analysis was fatally flawed because KPMG had determined that Hallmark Marketing was a "mere" distributor which possessed no valuable intangible assets. Dr. Shapiro believed that Marketing had many valuable intangibles, including: a well-trained sales force; expertise in site and owner selection and real estate negotiations; participation in design, development and manufacturing of display fixtures; engagement in trade name protection services; provision of sophisticated management tools to retailers; creation of a business-to-business website;

ownership of Hallmark stores; development of a customer loyalty card program; and most importantly, development and possession of a unique and valuable distribution channel granted to it by Cards. Dr. Shapiro reasoned that KPMG's assumption, that Marketing had no valuable intangibles, poisoned the selection of comparables and the interquartile distribution.

63. Dr. Shapiro devoted a significant portion of his expert report to brand equity and its positive effect on profit margin which results from price premiums charged for product. Greater brand equity produced a greater market share and a larger number of loyal customers allowing for price premiums. Greater brand equity also translated to lower marketing costs and a distinct competitive edge in the marketplace and greater revenue opportunities.

The value of retail equity was also analyzed by Dr. Shapiro. He stated that it was derived through meeting relevant customer expectations and developed through the decentralized actions of each store. It was heavily dependent on market positioning and market mix, the latter comprised of location, store design and display and customer service. Dr. Shapiro opined that Marketing's expertise in operations and supply chain management was critical to its success in developing a loyal customer base and building retail equity.

64. Dr. Shapiro reasoned that, since Marketing had the right to sublicense under the Distribution Agreement with Cards and only the owner of brand elements could license or lease them, Marketing was more than a "mere" independent distributor of product. Dr. Shapiro stated that an independent distributor would only be interested in economic benefits, not its relationship to Cards. Further, Dr. Shapiro believed an independent distributor would not have agreed to the inherent constraints on resale prices while simultaneously being deprived of enjoying the brand value benefits it would have obtained if it truly had been an "independent" distributor.

65. Dr. Shapiro noted that the KPMG report minimized the advertising and manufacturing aspects of Marketing's business saying that Marketing did not pay for advertising which generated brand value and did not own or have a beneficial right to any valuable trademarks or trade names. However, Dr. Shapiro downplayed the importance of manufacturing and trademark and trade name ownership, saying that the more emotional or highly involved the product and the brand choice decision, the more important are factors which create the brand's intangible value. He argued that Marketing's input to forecasting and merchandising to local levels was far more important to securing brand preference and loyalty. He noted the manipulation of store atmospheres through displays and designs as prime examples of contributors to brand equity, in addition to customer service, supply chain management and location of stores.

66. Dr. Shapiro underscored the importance of Marketing's role in selecting new owners for Hallmark stores, whereby it helped to create a network of hand-selected entrepreneurs committed to selling Hallmark products. In this way, Marketing was able to have a significant effect on the quality of retail customer service and on the value of the Hallmark brand.

67. In addition, Dr. Shapiro observed that Marketing contributed to brand value by testing new ideas in the stores he alleged Marketing owned through its subsidiary, Hallmark Specialty Retail Group. One example given by Dr. Shapiro was the five years of testing that was done for "Showcase" stores: stores twice the size of regular Hallmark stores with a focus on home decor and gifts. The test was performed in "Creations" stores, which Dr. Shapiro said were owned by Marketing.

68. Dr. Shapiro concluded that, although Cards may have created brand awareness and familiarity, it was Marketing's assistance to retailers that created brand loyalty, and therefore the majority of brand equity creation and maintenance must be attributed to Marketing's efforts.

Without specifying the amount or directing how to value its efforts, Dr. Shapiro stated that any compensation for Marketing's efforts must be based on more than the dollar cost of its efforts. In addition, although Cards may have had brand ownership, it was Marketing that used the brand and derived the benefit from its intangible value. In Dr. Shapiro's view, the right to use the brand and the right to exploit the brand's intangible value were inseparable and Marketing's activities clearly enhanced the value of the brand. However, given the very restrictive contractual relationship it had with Cards, it did not derive any residual claims from intangible brand value creation.

69. In concluding his remarks on Marketing's enhancement of brand equity, Dr. Shapiro stated that the intangible value of the brand assets was such that the ownership rights cannot be separated from the right to use them, and the right to use them cannot be separated from the right to exploit the intangible value of those assets. Without any comment on the calculation of an appropriate transfer price, Dr. Shapiro noted that any transfer price which tries to separate these rights must entail an analysis beyond the simple assignment of brand assets or the split of current profits from business transactions.

70. The second half of Dr. Shapiro's report addresses itself to the KPMG report and the methodology used therein. It was Dr. Shapiro's conclusion that every step of KPMG's analysis was based on incorrect assumptions or contained conceptual errors. As evident from his analysis reviewed above, KPMG's assumption that Marketing held no valuable intangibles was a critical and fatal flaw.

71. Dr. Shapiro listed what he believed to be KPMG's core contentions and disagreed based on his belief that Marketing did have valuable intangibles and, by ignoring them, KPMG placed a bias on its estimate of Marketing's return on its activities. The core contentions which

Dr. Shapiro identified and discussed in great depth in the first part of his report were that brand assets could be separated; that intangible brand value is derived from manufacturing and advertising only; that marketing activities and local programs could be compensated on the basis of their costs and not their impact; and that all residual claims from brand equity belong to the brand asset owner.

72. In Dr. Shapiro's view, KPMG's selection of the comparable profits method was consistent with its erroneous assumption that Marketing owned no valuable intangibles because it contemplates that the companies compared have no valuable intangibles. With respect to KPMG's selection of the Berry ratio as the profit level indicator, Dr. Shapiro noted that it was only a proper PLI for a very restricted class of distributors and should not have been used where a firm combined distribution with other functions. Therefore, it was an inappropriate PLI in this matter.

73. With respect to the comparables chosen by KPMG, Dr. Shapiro believed that the failure to acknowledge that Marketing had valuable intangibles poisoned the selection process. The KPMG quantitative screens applied to the 207 original comparables eliminated companies based on R&D expenses, advertising expenses, years of financial data and those with sales of less than 20 million dollars. These screens essentially eliminate companies with valuable intangibles like those Dr. Shapiro believed Marketing possessed. Therefore, the chosen comparables were not "comparable" to Marketing.

74. Dr. Shapiro commented that the adjustments to accounts receivable, accounts payable and inventory made to the Berry ratios of the comparables may have been appropriate to improve the comparability between the tested party and the comparables, but he disagreed with the interest charge applied by KPMG to the inventory because it expressed the adjustment to

inventory in nominal rather than present value terms, which he believed lowered the Berry ratios of the comparables.

75. Dr. Shapiro determined that KPMG miscalculated the Berry ratio of Marketing by not including depreciation in the denominator of the formula Gross Sales/Operating Expenses + Depreciation, thus inflating Marketing's Berry ratio in comparison to the comparables, which did include depreciation in the denominator.

76. Dr. Shapiro also noted that the adjustment made by KPMG for the sale of accounts receivable to HFC in 1999 had the effect of creating a larger adjustment for accounts receivable for all of the comparables than if it had utilized the 1996-1998 Marketing accounts receivable data. This use of the lower accounts receivable figure for 1999 resulted in a lower interquartile range for the nine comparables.

77. Without conceding that the KPMG report was not fatally flawed because it ignored valuable intangibles and considered Marketing a straightforward distributor, Dr. Shapiro made some adjustments of his own to illustrate that KPMG biased its results in making its adjustments. He changed the quantitative screen that eliminated companies with sales less than $20 million and increased that threshold to $500 million, a figure he said produced companies with a similar scale of operations. He also corrected misstatements of depreciation for several of the comparable companies, using data he found in the Forms 10-K. Dr. Shapiro also eliminated the use of 1999 data for accounts receivable and substituted the interest rate ratio for the inventory adjustment. He also subtracted depreciation from the denominator of the Berry ratio for each of the comparables to be consistent with KPMG's calculation of the Berry ratio of Marketing.

78. After making these adjustments, Dr. Shapiro determined that Marketing's Berry ratio of 1.10 fell outside the interquartile range for the entire KPMG data set, its broad list of

comparables and its narrow list. Dr. Shapiro set forth the following chart to summarize the results of his adjustments.

KPMG Data Set	Interquartile Range 96-98 Berry ratios before Corrections	Interquartile Range 96-98 Berry ratios after Corrections
All Companies	1.06 to 1.28	1.16 to 1.48
Broad List	1.06 to 1.25	1.16 to 1.43
Narrow List	1.02 to 1.19	1.13 to 1.36

79. The Division's second expert witness was Dr. Ednaldo Silva, who was accepted as an expert in economics and transfer pricing, particularly in the area of the Internal Revenue Code § 482 regulations. Dr. Silva, who earned a masters degree and PhD. in economics from the University of California at Berkeley, worked with the Internal Revenue Service in New York beginning in 1989 and one year later took a position with the Office of the Chief Counsel of the IRS in Washington, D.C., where he worked on the advanced pricing agreement program. He remained there for three years and then left to become the chief economist for the law firm of Sherman and Sterling, where he worked until 2001 when he opened his own business, RoyaltyStat LLC, which managed a database of license agreements. He has taught economics, statistics and econometrics for over ten years at the University of California at Berkeley and the New School for Social Research. He participated in the drafting of the regulations promulgated under IRC § 482 in 1993 (on the temporary regulations) and in 1994 (on the final regulations). Dr. Silva also has published numerous articles on transfer pricing.

80. Dr. Silva created a report which evaluated the arm's-length nature of intercompany transactions between Cards and Marketing in 1999 with particular attention to the provisions of Internal Revenue Code § 482 and the regulations thereunder. Dr. Silva observed that

approximately 75% of Marketing's operating expenses came from intercompany transactions. Dr. Silva described the "best method" rule for finding the most reliable measure of arm's-length transactions, the standards of comparability for determining the degree of comparability between controlled and uncontrolled transactions, transfer pricing methods for tangible goods and intangibles and the consideration which should be given for the provision of intercompany services.

81. Dr. Silva determined that the KPMG report was flawed for numerous reasons. He said KPMG's report focused on Marketing's distribution activities and purchases from Cards, while failing to address other critical intercompany transactions. Dr. Silva believed the most egregious omission was the sale by Cards to Marketing of raw materials used in the production of display fixtures at a 95% discount. The net result of such sales was the distortion of Marketing's cost of goods sold with the possibility of further distortion if the display fixtures loaned to customers were amortized in operating expenses. Dr. Silva believed that if the purchase price of materials were arm's length, the cost of goods sold would be higher and the gross profit lower, decreasing Marketing's Berry ratio. Hence, Dr. Silva concluded that the Berry ratio was unreliable as calculated by KPMG.

82. Dr. Silva criticized the KPMG report for not addressing the provision of general and administrative services to Marketing by Cards which was noted in the audited financial statements of Marketing as charged at actual cost. Dr. Silva noted that such charges, if at arm's length, should have included a profit and a recovery of all costs associated with the provision of the services. According to Dr. Silva, Cards charged only 35 million dollars to Marketing in 1999 but actual expenses were 49 million dollars. The result of this undercharge for general and administrative services was a higher, and distorted, Berry ratio. However, it is noted that the

audited financials for Marketing for 1999 do not include the figures used by Dr. Silva. His information was taken from electronic mail from a Hallmark employee, Buffy Walker, to Cards' Tax Manager, Mark Shaefer, on March 15, 2004.

The 1999 audited financial statement indicated that Cards paid general and administrative costs of $233,000,000.00, which were charged to Marketing at cost. In addition, Cards charged Marketing an administrative fee of $39,900,000.00.

83. Dr. Silva observed that the license agreement between Cards and Marketing, dated October 1, 1999, granted Marketing the use of valuable trademarks and tradenames without royalty charge. Further, Marketing did not charge retailers to whom it sublicensed the trade names and trademarks. It was Dr. Silva's position that under uncontrolled circumstances, a distributor would pay for the right to use and sublicense the trademarks and trade names. Thus, the absence of such an expense caused Marketing's operating expenses to be understated and the resulting Berry ratio to be higher and unreliable.

84. Dr. Silva noted that Marketing engaged in activities to protect the trademarks, including having its salesmen inspect retail premises to monitor use of said marks and names. Such intercompany services should have been considered and valued and Marketing compensated for its services. Dr. Silva stated that KPMG never addressed this issue in its report.

85. Another intercompany transaction which Dr. Silva said KPMG failed to accurately account for was the development of the Retail Operating Model ("ROM") which was a computerized system for inventory management, performance reporting, e-mail and warehousing support. The roll-out of this product had been estimated to cost $50 million, shared by Cards and Marketing. However, since the system addressed areas within the scope of Cards' business, Dr. Silva concluded that Marketing's share of the development cost should have been

compensated by Cards for its services or Marketing granted ownership rights, in which case Marketing would have owned an intangible.

86. Another weakness cited by Dr. Silva was the loss incurred on the sale of receivables to HFC in 1999 and KPMG's failure to address the issues raised thereby. The first was KPMG's treatment of the loss as an addition to cost of goods sold rather than as an operating expense. Dr. Silva pointed out that internal documents indicated that the loss was properly an operating expense, but accounted for in cost of goods sold, the former of which would have resulted in a lower Berry ratio. Dr. Silva claimed there was no authority for including the loss in cost of goods sold, and the recharacterization of the loss was done for purposes of transfer pricing only. In addition, Dr. Silva noted that KPMG did not analyze the arm's-length character of the sale of the receivables nor did it consider the sale when it selected comparables and whether it created a functional difference between Marketing and the selected companies. Dr. Silva also questioned whether KPMG made an adjustment to Marketing's accounts receivable for 1999 to correspond to the adjustment to cost of goods sold, to avoid double counting, since the lower level of accounts receivable after the sale of receivables caused a downward shift in the interquartile range when KPMG performed its asset adjustments.

87. Dr. Silva determined that KPMG erred in selecting the comparable profits method. He concluded that KPMG failed to do an accurate functional analysis of Marketing, the tested party, leading to the selection of improper comparables and the wrong profit level indicator.

88. With regard to the functional analysis, like Dr. Shapiro, Dr. Silva criticized KPMG for its characterization of Marketing as a straightforward distributor. It was noted that Marketing held no inventory, performed manufacturing functions and provided real estate, business brokerage and trademark protection services. In addition, Dr. Silva observed that Marketing had

a large market share and established distribution channels and also developed intangibles like ROM and MIX, a business-to-business website.[2] In addition, it was noted that there was some overlapping of personnel between Marketing and Cards producing an integration which generated synergies that were not taken into account by KPMG. Dr. Silva argued that not taking these functions into account poisoned all attempts to locate comparable companies and doomed the KPMG report to failure.

89. Dr. Silva said the two greatest mistakes were categorizing Marketing as a straightforward distributor which did not possess valuable intangibles and choosing comparables that were not straightforward distributors. He also noted problems with each of the comparables that he believed demonstrated they were not straightforward distributors:

a) Advanced Marketing published books and operated retail outlets;

b) Amcon sold its own brand of products and owned the trademarks related to them;

c) Celebrity designed and produced its own artificial floral products;

d) Color Spot Nurseries engaged in agricultural production, producing the property it sold;

e) Di Giorgio sold products under its own name, operated a retail grocery delivery website and operated only in the New York metropolitan area;

f) Globenet sold its products to independent distributors on what it described as a multi-level distribution network and reported only two years of operating results;

g) J.B. Williams produced its own products, owned valuable trademarks and relied on third parties to perform the distribution function;

[2] MIX (Marketplace Information Exchange) Inc. was a business-to-business website, which Marketing helped to develop but was operated by a separate legal entity that enabled retailers to order products on-line.

h) USA Floral Products was a start-up company with less than two years of operation. Dr. Silva, from his own investigation of the comparables from public records, determined that all except Daisytek owned registered intangibles while KPMG never stated that Marketing owned any.

90. Dr. Silva rejected KPMG's selection of the Berry ratio as the PLI in its application of the comparable profits method. He believed that the contaminated intercompany sales between Marketing and Cards which did not reflect an arm's-length charge for materials, general and administrative services and use of trademarks should have eliminated the Berry ratio as a PLI. In addition, Dr. Silva claimed that KPMG overlooked differences in accounting methods between Marketing and the comparables selected with specific reference to the composition of operating expenses. Without consistency in accounting for operating expenses the use of the Berry ratio was in error. Dr. Silva also noted that the use of the Berry ratio is not appropriate when comparing companies that mix distribution and manufacturing activities.

91. Dr. Silva observed that the Berry ratios derived for the nine comparables were based on different accounting methods. He concluded that the allocation of depreciation and amortization to cost of goods sold and operating expenses was not performed consistently by the nine companies, and therefore, the resulting computation of the Berry ratios was tainted.

92. Dr. Silva disagreed with the asset adjustments made by KPMG to equalize the differences between Marketing and the comparables. On a conceptual basis, he believed that since the level of current assets maintained by a company is correlated to sales, any adjustment of current assets must show that there is no such correlation. In the alternative, Dr. Silva argued that adjustments to inventory, accounts receivable and accounts payable were in error,

contaminated by KPMG's failure to accurately reflect transfer prices for fixture materials, general and administrative services and other intercompany transactions mentioned above.

93. Dr. Silva pointed out the interquartile range established by KPMG included a value which was below zero, indicating operating expenses greater than gross profit. He noted that this was incongruous with the economic reality that a firm operating at arm's length would not enter into transactions that produce operating losses.

SUMMARY OF THE PARTIES' POSITIONS

94. Petitioner argues that it should not be forced to file on a combined basis with Cards because its business, income, activities and capital in New York State were accurately reflected on its separate return for 1999. Although it concedes that it had substantial intercorporate transactions with Cards, Marketing believed it has rebutted the presumption of distortion such transactions raise.

95. Petitioner contends that it has adhered to the principles of IRC § 482 in demonstrating a proper reflection of its income and, by doing so, has rebutted any presumption of distortion. To this end, Marketing confirmed compliance with IRC § 482 by having an independent auditor, KPMG, perform a transfer pricing analysis of the transactions between Cards and Marketing for 1999. Said study determined an arm's-length price which was utilized by Marketing and Cards in setting the price charged for products sold.

KPMG followed IRC § 482 regulations in choosing the comparable profits method to determine arm's-length pricing and the Berry ratio as the profit level indicator which allows the comparison of profits among distributors. Under the IRC § 482 regulations, once a range of profitability ratios has been established, an interquartile range can be established using the ratios established for the tested party, here Marketing, and the comparables. Since petitioner's ratio fell within the interquartile range, it argues that the transactions with Cards were arm's length.

96. Petitioner contends that the Division's expert witnesses were unable to impugn the validity of the KPMG report or Dr. Cody's affirmation of same because they did not have an accurate understanding of the facts underlying the functions of Marketing and used assumptions which led to erroneous conclusions. In support of this position, petitioner points to Dr. Shapiro's belief that Marketing owned intangibles which were, in fact, owned by Cards; that he misinterpreted routine intangibles which were held by most independent distributors; that he continually characterized Marketing as a retailer, creating or enhancing intangible assets normally ascribed to retailers; that he assumed Marketing designed display fixtures when it was Cards that undertook the creative marketing role; and that he asserted that Marketing developed MIX, the business-to-business website, when it primarily was developed by a separate and distinct legal entity.

97. Petitioner contends that the Division's experts failed to compromise the selection of comparable companies because KPMG acted consistently with the IRC § 482 regulations and identified companies with like characteristics, particularly the value-added services performed by each and that the Division's experts would have been satisfied only with "perfect," nonexistent comparables.

98. Petitioner also argues that, regardless of the determination with regard to the issue of combination, penalty should be abated because it acted in good faith and with substantial legal authority given the effort and expense it incurred to ensure its transactions were arm's length.

99. Finally, petitioner argues that if the State of New York is permitted to force it to combine with Cards, it will be taxing value (the income of Cards) earned outside its borders which is prohibited by the Due Process and Commerce Clauses of the United States Constitution.

100. The Division of Taxation counters the arguments of petitioner, contending that the transactions between Cards and Marketing could not have been arm's length because it was established that Marketing owned and employed valuable intangibles or unique assets for which it was not compensated. The Division identified various intangibles including Marketing's distribution network, its large market share, customer lists, the Hallmark trademarks which were licensed to it, its development of MIX and ROM, test stores and a highly skilled workforce.

101. The Division argues that Marketing was not compensated for services it performed for Cards that enhanced the value of intangible assets owned or co-owned by Cards. These services included trademark protection, manufacturing display fixtures, business brokerage, real estate services to Gold Crown stores; the creation and mailing of Gold Crown catalogs to consumers and retailers; and involvement with the Hallmark Keepsake Collector's Club.

102. The Division challenges the comparative profits methodology based on the lack of reliability of the financial numbers used for the tested party. The Division charges that Marketing did not submit any evidence to demonstrate that its audited financial statements for 1999 were accurate since there was nothing to show that it dealt on an arm's-length basis with all of the members of the Hallmark family, vis-a-vis, Cards, SRG and Retail Plans, such that the numbers accurately captured the synergies and interdependencies that existed between it, Cards and its two subsidiaries. Further, the Division notes that KPMG and Dr. Cody relied on unaudited financials for the years 1997 and 1998.

103. The Division contends that if Marketing did not accurately account for its operating expense and cost of goods sold, the effect on the Berry ratio and the arm's-length price derived therefrom would be distorted. It believes several factors support this claim. The Division argues that the general and administrative charges charged by Cards were understated by $14 million. The raw materials purchased by Marketing for 5% of cost were not purchased at arm's length, thus understating the cost of goods sold and distorting the gross margin. Finally, since none of petitioner's experts addressed the transactions with petitioner's subsidiaries, the Division argues that it cannot be found that any of those transactions were arm's length, and thus, as a component of cost of goods sold or operating expenses, they would cause more distortion of the Berry ratio.

104. The Division challenges the use of various databases by KPMG and Dr. Cody, noting that the Compustat database "normalized" data, removing depreciation and amortization from cost of goods sold and operating expenses. The Division contends these differences poisoned Dr. Cody's opinion, which used different databases.

105. The Division, for the reasons raised by its experts, contends that the comparables chosen by KPMG and affirmed by Dr. Cody were not reasonable under the principles of IRC § 482.

106. The Division argues that the penalty was properly imposed and should be sustained because Marketing knew that the loss on the sale of receivables was treated as an operating expense for transfer tax purposes but added it to cost of goods sold thus inflating the Berry ratio. Since KPMG and Marketing's tax department knowingly agreed to this accounting, reliance on the KPMG report for abatement of penalty was weakened and should not provide a basis for canceling the penalty.

107. Finally, the Division contends that petitioner's Due Process and Commerce Clause arguments are without merit since they are based on having demonstrated that the tax asserted was out of all proportion to the business transacted by it in New York State. Since petitioner has not shown such an error by the Division herein, the argument must fail.

CONCLUSIONS OF LAW

A. The central issue is whether Marketing's corporation franchise tax liability as set forth on its separate New York State return for 1999 accurately reflected its business, income, activities and capital in New York. If it is determined that Marketing's business, income, activities and capital were not accurately reflected, then the Division may require Marketing to file on a combined basis with Cards in order attain an accurate presentation of Marketing's income attributable to New York.

Authority for this is found in Tax Law § 211(4) which states, in relevant part, as follows:

> In the discretion of the commissioner, any taxpayer, which owns or controls either directly or indirectly substantially all 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 . . . , 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 commissioner may require; . . . provided, further, that no combined report covering any corporation not a taxpayer shall be required unless the commissioner deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article . . . .

The regulations promulgated pursuant to this section provide that the Division may require or allow the filing of a combined report where three conditions are met. The first two are found in 20 NYCRR 6-2.2, where it states that the taxpayer must own or control, either directly or indirectly, substantially all of the capital stock of the corporations which are to be included in the combined filing (20 NYCRR 6-2.2[a]), and whether the activities in which the corporation engages are related to the activities of the other corporations in the group (20 NYCRR 6-2.2[b]). These conditions are commonly referred to as the capital stock and unitary business requirements. In this matter, petitioner has conceded that these conditions exist.

Where these first two requirements have been met, the Division may require combined reporting if reporting on a separate basis distorts the activities, business, income or capital of the taxpayer, in this case Marketing. Distortion is presumed when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations. (20 NYCRR 6-2.3[a].) That there were substantial intercorporate transactions between Marketing and Cards is not disputed, only whether they distorted the income, activities, business or capital of Marketing when filing on a separate basis in New York.

B. The presumption of distortion, as referred to in 20 NYCRR 6-2.3(a), can be rebutted by the taxpayer by showing that the transactions between the corporations were at arm's length (***see***, ***Matter of USV Pharm. Corp.***, Tax Appeals Tribunal, July 16, 1992; ***Matter of Standard Mfg. Co.***, Tax Appeals Tribunal, February 6, 1992). In ***Matter of Standard Mfg. Co.*** (***supra***), the Tribunal determined that the applicable standard was the proper reflection of income and that where the stock ownership, unitary business and substantial intercorporate transactions tests prescribed by the Division's regulations are met, a presumption of distortion arises which the taxpayer has the opportunity to rebut by showing that filing on a combined basis is not necessary to properly reflect income in order to succeed in its assertion that filing on a separate basis is appropriate. As the Tribunal noted in ***Matter of Silver King Broadcasting of N.J., Inc***. (Tax Appeals Tribunal, May 9, 1996), where the taxpayer rebuts the presumption of distortion, the Division, in order to require combination, must show why it believes that reporting on a separate basis does not properly reflect income. It is not sufficient for the Division merely to identify possible areas of distortion; it must, at a minimum, identify with particularity the activities or transactions which give rise to distortion and must explain how distortion arises from such activities or transactions.

C. The Tax Appeals Tribunal has held that it is appropriate to apply the principles of IRC § 482 to determine whether arm’s-length pricing between related entities exists. In ***Silver King (supra)***, the Tribunal stated that in the absence of Federal section 482 adjustments, it is appropriate to apply the principles of section 482 to show arm's-length pricing because the purposes of that provision and of Tax Law § 211(4) are similar (***Matter of USV Pharm. Corp., supra***) and there is no other source of guidance for identifying an arm's-length relationship ***(Matter of Campbell Sales Co.***, Tax Appeals Tribunal, December 2, 1993).

The stated purpose of IRC § 482 is to prevent the avoidance of taxes by ensuring that taxpayers clearly reflect income attributable to controlled transactions (Treas Reg §1.482-1[a][1]). In order to determine the true taxable income of a controlled taxpayer, the standard to be applied is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer (Treas Reg § 1.482-1[b][1]). In selecting the best method to use in determining the most reliable measure of an arm’s-length result, the two primary factors to be considered are the degree of comparability between the controlled transaction and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. (Treas Reg § 1.482-1[c][2].) That said, the best method rule does not prescribe any one method, stating that it assumes no method will be more reliable than any other and that an arm’s-length result may be determined under any method without establishing the inapplicability of another method. (Treas Reg § 1.482-1[c][1].)

D. Petitioner was created by Cards in 1963 and assumed principal sales functions sometime prior to the year in issue. Essentially, Marketing was created to perform a function historically managed by Cards, i.e., the sales and distribution of Hallmark products. The extent to which Cards successfully transferred its sales and distribution function to a wholly-owned subsidiary is the measure of its effort to rebut the presumption of distortion.

Using IRC § 482 and the regulations thereunder as a guide in establishing arm's-length pricing to rebut the presumption of distortion, KPMG selected the comparable profits method ("CPM") for determining the arm's-length result of the controlled transactions between Cards and Marketing, with the understanding that comparability and the quality of its data and assumptions used in its analysis would be paramount.

An arm's-length result under the CPM is based on the amount of the operating profit that the tested party would have earned on the related party transactions if its PLI were equal to that of the uncontrolled comparable. The comparable operating profit is found by applying the PLI to the tested party's most narrowly identifiable business activity (financial data related to controlled transactions) for which data is available. The resulting operating profit is compared with the uncontrolled comparable operating profits to determine if the reported profit of the tested party is arm's length (Treas Reg § 1.482-5[b][1]) and if it falls within the arm's-length range established using comparable operating profits derived from a single PLI (Treas Reg § 1.482-5[b][3]).

Since Marketing performed sales activities and functions that are common to many distributors for which financial data were publicly available, it was reasonable for KPMG to conclude that there would be many potential CPM comparables from which an arm's-length range could be established. KPMG also noted that the CPM was less affected by fluctuations in functions performed. (Treas Reg § 1.482-5[c][2][ii].) In addition, the CPM was less affected by variations in accounting classifications of items among sales, cost of goods sold and operating expenses. Other methods were more sensitive to these factors and, hence, less reliable.

The goal is not to find a perfect or identical comparable, but one which is sufficiently similar, so as to render a reliable measure of an arm's-length result. (Treas Reg § 1.482-1[d][2].) Any material differences between the tested party and uncontrolled taxpayers can be addressed by adjustments to improve the reliability of the results, including asset adjustments like the ones made by KPMG herein for inventory, accounts receivable, accounts payable and the manufacturing function. (Treas Reg § 1.482-1[d][2];Treas Reg § 1.482-5[c][iv].)

For its PLI, KPMG selected the Berry ratio because it believed it was well suited to a distributor like Marketing. The Berry ratio is gross profit divided by operating expenses, which reflects the returns earned for performing its functions as a distributor. As mentioned in the facts, the ratio assumes that the distributor's operating expenses reflected the level and intensity of the reselling function it performs, thus reflecting the return earned for performing these functions.

Any criticism of KPMG's choice of the Berry ratio based on the fact that petitioner also manufactured fixtures is unfounded, given the very small scale of those operations and the facts and circumstances surrounding that function, which will be addressed below. Treas Reg § 1.482-5(b)(4) lists the factors to be considered in choosing the correct PLI, including the nature of the activities of the tested party, the reliability of available data for uncontrolled comparables, the reliability of the PLI in measuring profit between the tested party and controlled parties at arm's length, taking into account all the facts and circumstances. The arm's-length range is derived by application of a valid statistical method to the results of all the uncontrolled comparables in order to assemble a range of comparable profitability ratios to compare against the tested party. (Treas Reg § 1.482-1[e][2][iii][B].) The most common valid statistical method referred to by the regulation is the interquartile range, i.e., the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. Although another statistical method may be employed, it must be demonstrated that it is a more reliable measure. To the extent that Dr. Silva preferred a 50% confidence interval, it was not demonstrated by the Division that this was more reliable than the interquartile range under the facts and circumstances of this matter.

E. Under all the facts and circumstances, Marketing has demonstrated that its intercompany pricing with Cards was at arm's length, consistent with IRC § 482. It has successfully rebutted the presumption of distortion and should not be forcibly combined with Cards under Article 9-A of the Tax Law for 1999. This determination is based on an acceptance of the sound and thoroughly prepared report of KPMG, which was consistent with the IRC § 482 regulations, the confirmation of KPMG's process and assumptions by Dr. Cody's independent analysis and the successful defense of both against the criticisms leveled by Dr. Shapiro and Dr. Silva.

Ultimately, this case must decide whether the analysis performed by KPMG was consistent with the reasonable and flexible approach suggested by IRC § 482, which recognizes the difficulty taxpayers face when trying to meet an arm's-length standard - - where the results of a controlled transaction are consistent with those realized between two uncontrolled taxpayers under the same circumstances. However, as mentioned above, since identical transactions are rare, arm's-length results will be determined from comparable transactions under comparable circumstances. (Treas Reg § 1.482-1[b][1].)

F. The parties disagreed over the most basic underpinning of the KPMG pricing study: the function of Marketing. While KPMG described petitioner as a distributor performing common functions associated with such an entity, the Division believed that petitioner was a far more complex corporation, inextricably linked with Cards and anything but a common distributor.

The Division's concept of a traditional distributor, though never clearly defined, seems to be analogous to a common carrier, an entity that performs its sole function with no additional value-added services and primarily concerned only with its own economic benefit. But this is not the reality that presented itself in the evidence adduced in this matter. To some degree, most distributors will add value to the services they perform through intangibles like a skilled sales force, advertising, or a distribution network in order to make their services more attractive, effective and profitable. However, this is distinct from creating retail or brand equity as argued by the Division. Marketing's employees did not work for retail stores or provide customer services which created retail or brand equity that added value to the Hallmark business.

Marketing's identity was established by its distribution agreement with Cards and was affirmed by the independent international distribution agreements Cards had with companies like Gulf Greetings, Rakah and Keaton International, which described substantially similar, although not identical, relationships. The Division's experts and auditors failed to demonstrate the facts underlying the complexities they alleged existed, which had a direct impact on arm's-length pricing, while the distribution function was well settled by the terms of the distribution agreement, the testimony of Rod Sturgeon and the KPMG report.

The Division was concerned that Marketing created and held valuable intangibles which it identified as its distribution network, large market share, customer lists, use of Hallmark trademarks without royalty, its development of MIX and ROM, its use of test stores and a highly skilled workforce. The Division reasoned that these intangibles must have created and added to the value of the Hallmark brand, and the prices charged between Cards and petitioner did not compensate Marketing for its contribution to brand or retail equity. But the record does not support the assertion that Marketing held intangible organizational assets necessary to deliver on the brand promise of "caring enough to give the very best." Those were within the creative function of Cards. Marketing was compensated only for distribution-linked intangibles and functions, in the same way independent distributors were treated by Cards.

As pointed out by Dr. Cody, the intangible argument is not persuasive. Dr. Shapiro did not differentiate between a theoretical economic reality and the legal reality that Marketing owned no retail stores and did not contribute to retail brand equity as a retailer. His inability or refusal to acknowledge that a subsidiary, SRG, owned and operated retail stores was a material flaw in his arguments that created a logical fissure which required a leap of faith for one to accept that Marketing was able to create brand or retail equity for which it was not compensated. Since Marketing distributed to thousands of retail outlets in the mass merchandise and specialty/retail channels, which themselves created retail equity for the outlets vis-a-vis their own competitors in their own sectors, it cannot be found that the retail and brand equity created should be attributed to Marketing. Dr. Shapiro's economic theory requires one to dismiss the legal entities within the Hallmark group, created and maintained by Hallmark for many different and valid business reasons, including tax planning, and assume that parent and subsidiary are one entity. Perhaps this failure to give credence to the separate legal identities is an extension of Dr. Shapiro's and the Division's basic inability to separate Cards and Marketing as well. Further evidence of Dr. Shapiro's confusion was his assertion that Marketing's employees have an allegiance to the Hallmark organization and products which is not found in common distributor arrangements. He could not or would not accept that employees in a unitary business could share a common desire for the organization to succeed without adding value to the distributed product and affecting the arm's-length price of that product. Other than his assertion of this theory, there was no support for it in the record and it is rejected as speculative.

The Division repeatedly misconstrued Card's role in creative activities, from the design of greeting cards and display fixtures to advertising and ownership and control of the trademarks and trade names. From the facts in evidence and the credible testimony of Rod Sturgeon, it was established that the planning, creation, design and delivery of cards and product occurred at Cards, as did product, trend and consumer research activities. Further, it was Cards that developed the concept of the Gold Crown Program, where customers' purchases were tracked and rewarded with discounts and promotions. The Division's misconceptions with regard to these factors permeated its experts' reports and opinions, leading to incorrect conclusions with respect to whether various activities actually created a value that was not considered when establishing an arm's-length price for product.

G. From a functional perspective, the fixture manufacturing operation was not a material portion of Marketing's business, contributing less than 5% to total operating expenses.[3] Further, KPMG did a credible job of recognizing the appearance of a functional aberration and chose to separately analyze it. KPMG looked at comparable manufacturing companies and calculated the return on assets for them and made the assumption that Marketing's return on assets was the median of this range. Then, KPMG took that median value and used it to weight the Berry ratios

[3]This is not the misuse of the Berry ratio contemplated by Charles H. Berry, author of "Berry Ratios: Their Use and Misuse," 1 Global Transfer Pricing, June-July 1999, PP.47-56. First, KPMG was aware of this issue when it prepared its report and noted that the operating expenses associated with manufacturing fixtures was only 5% of total expenses. Second, fixture manufacturing was not a core function and was done, of necessity, as a part of marketing the product because it was not possible or feasible for third parties to do it. Finally, the Berry ratios for the comparables was adjusted to accommodate for the manufacturing and there was no effect on Marketing's inclusion in the resulting interquartile range.

of the narrow group of comparables. The result was that there was a negligible impact on the ratios and the range. Therefore, the conclusion by KPMG, confirmed by Dr. Cody and agreed to herein, was that the fixture manufacturing operation did not have a material impact on Marketing's business or the IRC § 482 analysis and did not form a basis for undermining the comparables chosen.

H. Treas Reg § 1.482-1(f)(2)(i) suggests that the effect of separate transactions may be considered if they are so interrelated that it is the most reliable means of determining arm's-length consideration for controlled transactions. KPMG chose not to analyze the fixture materials agreement for the purchase of raw materials at 5% of cost or the royalty-free trademark license agreement separately, believing that the two factors were so closely interrelated with the distribution function that a separate analysis was unwarranted.

The integration of the fixture materials agreement with the distribution function has been discussed above in relation to the production of display fixtures and it is concluded that there was no further reason to separately analyze the fixture materials agreement.

With respect to the trademark licensing agreement, it must first be noted that the license did not, as the Division argues, grant Marketing the right to exploit the marks at its discretion in any way it desired to produce revenues for itself. The nonexclusive license was restrictive in that it contemplated the use of the marks in the marketing and distribution of greeting cards and other Hallmark products and the sublicense to retail stores for the same purpose. Petitioner contends correctly that products with the Hallmark trademark attached, or embedded, were transferred to it with no additional rights in the intangible other than the right to resell the product. (Treas Reg § 1.482-3[f].) In addition, the sublicense to retailers was also royalty-free, earning Marketing no further income thereon. These provisions are similar to the provisions found in the independent agreements with the international distributors, representative of good faith arm's-length pricing with uncontrolled taxpayers and integrated with the distribution function. The trademark protection that Marketing afforded Cards was no different from the protection promised by independent international distributors as set forth in the provisions of their distribution agreements.

I. Undeniably, Marketing provided management assistance to some retailers, including real estate services, assistance in site selection, and use of management tools like "ROM." Obviously, these services were provided only to specialty retail card stores, not the mass market stores like Walmart, thus limiting the percentage of retailers that would have benefitted from such services. Further, several of the comparables in the narrow group provided management assistance to retailers. Advanced Marketing, Amcon, Celebrity, Daisytek, and Di Giorgio all stated in their 10-K reports that management tools were shared with retailers to enhance business, indicating that these services were ordinary distributor functions.

The Division also believed that Marketing's help in the development of the Management Information Exchange, or "MIX," was a function that was not present in average distributors and added economic value to the Hallmark brand that was not considered by KPMG. However, a review of the Forms 10-K for the narrow group of comparables indicated that several utilized web resources to enhance business relationships. Daisytek, Di Giorgio and Advanced Marketing all used web solutions to interact with customers and assist in their business needs. Further, Marketing helped develop MIX only during some period in 1999 and it was not implemented until 2000 (after this audit period), and even then it was owned and maintained by a separate and distinct Hallmark corporate entity - - not Marketing.

Likewise, Marketing's involvement with the Gold Crown Catalogs and the Keepsake Collectors Club, discussed in the facts, were *de minimus* operations, found to have had no appreciable impact on the core function of Marketing and which did not amount to valuable intangibles that were overlooked by KPMG in its pricing study.

J. The Division made many allegations concerning the selection of the Berry ratio. It argued that the failure of petitioner to consider the alleged discounted amount of general and administrative expenses was a factor that held drastic consequences for the validity of Marketing's Berry ratio.[4] However, the discrepancy, $14 million, was insignificant given the total operating expenses for Marketing in 1999 of $362,940,000.00. Thus, even assuming the validity of the amounts (not clear from the record), the impact on the Berry ratio was minimal and did not materially affect the ratio.

The Division contended that the manufacturing operations of Marketing as well as the comparables made the choice of the Berry ratio inappropriate. But the manufacturing operations of the comparables were either accomplished by third parties or of minimal proportions. Amcon's private label products were manufactured by third-party companies and comprised a very small portion of its operations. Di Giorgio contracted for the production of its "White Rose" brand products that comprised only about 4% of its total sales. Advanced Marketing admittedly published books, but only a very limited number through its in-house publishing. Celebrity designed and produced products, the work for which was performed by third-party manufacturers under its direction, similar to the contract work Marketing had had done for it on some display fixtures. Therefore, the fact that some of the comparables had *de minimus*

[4]It is noted here, as it was in the facts, that the audited financials in the record do not reflect these amounts, undermining the weight that can be accorded to them. The figures used by Dr. Silva and addressed by petitioner on rebuttal were derived from an electronic mail communication.

manufacturing functions did not make them inappropriate choices and they were not fatal to the use of the Berry ratio.

_____The Division argued that the treatment of depreciation and amortization by the comparables was not consistent. Dr. Silva stated that Mergent, one of the databases used by Dr. Cody, did not normalize its data while Compustat did, such that the comparables used different accounting methods with respect to the allocation of depreciation and amortization between COGS and operating expenses. If true, this would affect the computation of the Berry ratio. However, Dr. Cody understood the problems with this aspect of the databases and used information provided by the Forms 10-K for two of the comparables whose information was not available from Compustat.

The Division argues that petitioner failed to adequately address Marketing's transactions with its subsidiaries, i.e., whether such transactions were at arm's length, therefore creating a distortion of the Berry ratio through a skewed cost of goods sold or operating expenses. This allegation stems from a statement of Dr. Silva which was based on his observation that about 75% of the operating expenses came from intercompany transactions. However, as Dr. Cody noted, most of these transactions were mere movements of cash between Cards and Marketing for payroll and benefits. Cards paid the salary and benefits of Marketing employees and was reimbursed for it. All the charges were on Marketing's books and had little effect on operating expenses or the Berry ratio.

Dr. Silva criticized the interquartile range established by all the Berry ratios for the comparables based on a value of less than 1.0, saying that in reality no business operating at arm's length would enter into transactions that produced operating losses. This appears to be speculative and does not address other reasons why a company may have a Berry ratio of less than 1.0. None of the companies that had such ratios repeated them and only one, Color Spot, had a three-year weighted average below 1.0, and that was due to a low ratio in 1997. In 1998 and 1999 its ratios were within the interquartile range.

Finally, the Division's contention that the sale of Marketing's accounts receivable to HFC in 1999 was double counted by allowing for a loss on the sale of receivables and also allowing for returns and allowances against gross receipts is rejected. As stated in the facts, Marketing sold its accounts receivable to HFC in May 1999 at 19.9% of face value. The discount was to take into account returns and allowances plus a time value of money and bad debts. The loss on receivables was treated as an acceleration of returns and allowances. While Dr. Cody chose to account for the loss by decreasing sales, KPMG accounted for it by increasing the cost of goods sold. Therefore, the resulting loss had no impact on the calculation of the Berry ratio.

In addition, it appears that the Division overlooked the fact that the smaller amount of returns and allowances was largely due to the fact that receivables arising between January and May of 1999 were collected and the returns and allowances for that period were placed on the books of Marketing. This accounted for the drastic reduction in accounts receivable for 1999 and presented such a stark relief from 1998 and prior years.

K. Dr. Silva criticized the Charles River report for using what he termed a mix of historical and restated numbers leading to incorrect income figures. However, the data acquired by Dr. Cody from Compustat consistently used restated numbers for the years 1999, 1998 and 1997, thereby insuring that acquisitions, dispositions or other material changes in the course of a fiscal year were captured and presented a consistent view of income statements and history within the company.

L. The previous discussion has established that the functional analysis of KPMG reached a sound conclusion in determining that Marketing was primarily a distributor performing activities routinely associated with that function. It was acknowledged that Marketing performed other functions as well, but none constituted more than an insignificant portion of its business operations and all were integrated with and supportive of its primary purpose.

KPMG searched three financial information databases for comparable companies in the standard industrial classification of wholesale distributors of nondurable goods and found 207 companies. To this list KPMG applied screens to eliminate companies that spent significant resources on developing intangibles, those with average sales for the previous three years of $20 million and those with less than two years of financial statement data to narrow the list to 101 companies. A very select group of comparables, nine in number, was then culled from the broader list using a more subjective screen involving an analysis of the Forms 10-K and a detailed business description for each company. KPMG included in its screening process a sensitivity to companies that provided value-added services but a lack of intangibles or companies that considered intangibles to be central to business operations.

In ***Matter of Tropicana Product Sales, Inc.*** (Tax Appeals Tribunal, June 12, 2000), the Tribunal acknowledged that comparables must be carefully chosen if an expert's transfer pricing report is to be accepted, but conceded that comparable did not mean identical (citing ***Bausch & Lomb v. Commissioner***, 933 F2d 1084, 1091). In ***Tropicana***, the petitioner was unable to establish the reliability of the set of comparable companies it found through a search of several databases. Tropicana's choice of two start-up corporations was harshly criticized by the Tribunal as was a purchasing co-op. In addition, the Tribunal noted the transfer pricing report's failure to address the difference in geographic markets, and, most influentially, functional comparability.

Tropicana sets the stage for the proper IRC § 482 analysis, but the facts are clearly distinguishable from this matter. In ***Tropicana***, there was no contract or distribution agreement indicating the pricing between the related parties and the compensation was a stagnant 1% of gross receipts that remained unchanged for more than 10 years without any accommodation for fluctuations in the economy or changes in the Tropicana corporate group. By contrast, Cards and Marketing utilized a sophisticated methodology that was updated to assure arm's-length pricing in light of current circumstances. This underscores the fact-driven nature of forced combination cases in general and the standards of proof necessary to rebut the presumption of distortion.

As noted earlier, IRC § 482 contemplated a comparable transaction that was not identical to an uncontrolled transaction, but "sufficiently similar." Further, it required a comparison of the functions performed and the resources employed in economically significant activities. (Treas Reg 1.482-1[d][2].) Of course, the Division's interpretation of this purposely vague section is that the transactions must be more highly comparable, while petitioner's view is that the transactions be only loosely comparable. What is certain is that the KPMG pricing study was far more exacting and thorough than the report prepared by Price Waterhouse in ***Tropicana***, and unlike that report, was prepared in 1999 and presented to the Division on audit, not ten days prior to hearing. Unfortunately, the Division's consideration of the report did not begin until the Notice of Deficiency was issued.

M. Both Dr. Silva and Dr. Shapiro saw the functions of Marketing as much more than a distributor. They believed that the business of Marketing included primary functions of merchandising, forecasting, store design, location and product selection. They placed particular importance on its role in trademark protection, advertising, manufacturing and installation of display fixtures, real estate services, owner selection, creation of management tools like ROM and MIX, development of owner loyalty programs like the Keepsake Club and the Gold Crown Card and ownership of stores. However, as was discussed and determined above, these functions were not central to Marketing's core business of distribution and sales, but were less significant activities that amounted to value-added services one would expect from a high volume distributor. Nor is it determined that by providing value-added services Marketing was creating intangibles or adding value to existing intangibles for which it was not compensated in the transfer price. KPMG was aware of the services performed and explained the economic significance of each, in many cases indicating the dollars associated with the activity where an actual dollar figure could be ascribed to it. In addition, Marketing contractually agreed to relinquish any claim it might have had on any goodwill it earned while using Hallmark trademarks and trade names, royalty-free, in the course of its distribution activities, under terms virtually identical to independent international distributors with which Cards contracted. In fact, the trade-off of royalties for goodwill appears to have been the underlying *quid pro quo* in the agreement.

Interestingly, like Marketing, the nine comparables perform services that enhance the product they sell and support those who sell the product at retail. In the summaries of the business descriptions for the comparables, it was apparent that they were involved in merchandising, inventory replenishment (often assisted by computer), sales forecasting, promotions, advertising, creation of planograms, web based sales, design and set-up of retail areas, sponsoring trade shows, reordering and restocking services, counseling in retail operations, equipment planning, store engineering, sanitation and security services. These were not core functions but support for their core function, i.e., sales and distribution.

N. The Division criticized the comparables due to their relatively small size in relation to Marketing on the basis of sales. The regulations clearly include the size and scope of a company's operations as a relevant factor when considering comparable uncontrolled taxpayers under the comparable profits method. (Treas Reg § 1.482-5[c][2][i].) However, Dr. Novos explained that his screen was deliberately employed to assure a proper size of a comparable's operations and that his method was rooted in a test KPMG performed to eliminate any scale effect that may have come up with smaller comparables. Since his analysis considered the size criteria specified in the regulation and adjusted his selection of comparables based on said analysis, it is determined that the Division's criticism, offered without a similar analysis, is without merit.

O. Treas Reg § 1.482-1(d)(3)(iv) suggests that certain economic conditions should be examined to establish the degree of comparability, including the similarity of geographic markets. (Treas Reg § 1.482-1[d][3][iv][A].) The Division's criticisms on this point center on the foreign operations of Daisytek and USA Floral. However, neither company failed the screen for being a foreign corporation or having earned more than 20% of revenues from foreign operations.

In ***Tropicana***, the Tribunal noted that different geographic markets can affect the prices charged and held that Tropicana had the burden in that case of showing that the different geographic markets did not impact upon the comparability. In ***Tropicana*** this factor was significant because Tropicana sold a substantial amount of its product in the northeastern United States, while several of the selected comparables did not.

Here, the record indicated that Amcon operated in a large geographic area including the Great Plains and the Rocky Mountain region. DiGiorgio operated in the New York metropolitan area serving grocery chains and independent grocers and was chosen as a comparable based upon its very strong functional equivalence with Marketing. In fact, its Berry ratio was extremely high and elimination of this comparable would have the effect of lowering the interquartile range and raising petitioner's placement among the comparables.

The Division also questioned the reliability of USA Floral based on the fact that it was a start-up company with less than three years of financial data. USA Floral had the lowest Berry ratio of all the companies within the interquartile range. However, Dr. Novos used the financial information he had from his databases for two years, which included a partial year of operation. His results were confirmed by Dr. Cody in his report, which utilized data from 1999 and a separate calculation of return on sales and return on assets, affirming the results reached using the Berry ratio. All of Dr. Cody's tests confirmed USA Floral's inclusion in the interquartile range and its profitability. Given these results, it is found that the Division's doubts are unfounded and USA Floral was properly selected as a comparable distributor.

In sum, petitioner has demonstrated through the KPMG report and Dr. Cody's report and testimony that the comparables were acceptable within the scope of IRC § 482 and the regulations thereunder. Each made purchases of products for resale; distributed its products to retailers; provided value-added services to customers; provided advertising or other marketing services to customers; monitored retail operations; did not own significant intangibles; did not operate significant retail operations; did not have significant manufacturing operations; and had sufficient financial data upon which to accurately portray its profitability and place it in the interquartile range.

P. In ***Silver King Broadcasting of N.J., Inc.***, the Tribunal affirmed the Administrative Law Judge in her own language which speaks to this case as well:

> 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.

The Hallmark companies present a vast and complex business which was only partially revealed in testimony and evidence received in this case. However, complexity and a unitary business do not equate to a conclusion that Marketing was not operating on an arm's-length basis with Cards in its transfer pricing. In fact, the KPMG study and Dr. Cody's reports have rebutted the presumption of distortion. Although the Division's criticisms were genuine they often lacked specificity. As the Tribunal stated in ***Silver King***,

> It is not sufficient for the Division merely to identify possible areas of distortion; it must, at a minimum, identify with particularity the activities or transactions which it claims give rise to distortion and explain how distortion arises from such activities or transactions.

And where there was specificity, petitioner successfully explained its activities and practices.

Q. Although the issue of penalty is moot given the conclusion reached above, for purposes of affording a two-tier level of review of this issue, it is determined that even if petitioner had been required to file on a combined basis with Cards, penalties would have been abated. Tax Law § 1085(k) provides for a penalty to be imposed for substantial understatement of tax in the amount of ten percent of the amount of any underpayment attributable to the understatement. The same section provides that the penalty may be waived if the taxpayer demonstrates reasonable cause for the underpayment or that it acted in good faith.

The fact that petitioner had a transfer pricing report prepared contemporaneously by KPMG upon which it relied to set its prices and file its returns for 1999 is ample proof that it acted reasonably and in good faith. The Division's arguments in opposition are based on alleged flaws in the KPMG report. But these arguments were all formulated after issuance of the Notice of Deficiency, even though it had the KPMG report for at least 15 months during the pendency of its 29-month field audit and chose not to meaningfully consider it until after the Notice of Deficiency was issued. Further, its allegations that petitioner and its employees knew or should have known that there were errors in the report are speculative and contrary to the very statement in the report that it was prepared consistent with the economic principles and standards of IRC § 482.

The Division contends that the discussion between petitioner and its expert concerning the placement of the loss on the sale of receivables demonstrated that petitioner acted in bad faith, knowing that the loss had been deliberately misplaced. However, as the record indicated, petitioner deferred to KPMG's expertise and fully relied on its advice relative to transfer pricing.

The regulation at 20 NYCRR 2392.1(g), dealing with reasonable cause under Tax Law § 1085(k), states:

> 2) In determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability. In addition to any relevant grounds for reasonable cause as exemplified in subdivision (d) of this section, circumstances that indicate reasonable cause and good faith with respect to the substantial understatement or omission of tax, where clearly established by or on behalf of the taxpayer, may include the following:
>
> * * *
>
> (iv) the reliance by the taxpayer on any written information, professional advice or other facts, provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer upon inquiry as the whether such facts were erroneous.

It is determined that, given all the facts and circumstances of this matter, petitioner has established that it acted in good faith when it relied on the KPMG report which it had no reason to believe was not honest, accurate and consistent with IRC § 482. The credible testimony of Dr. Novos and Rod Sturgeon serve to further confirm and support this conclusion.

R. There is a second issue that is rendered moot and not reached herein. However, for purposes of affording the two-tier review, if petitioner had been required to file on a combined basis with Cards, petitioner's argument that combination with Cards is prohibited by the United States Constitution because it would tax income of Cards outside New York State is without merit. As the Division correctly noted, the real issue is whether New York is properly apportioning income to New York that is not out of all appropriate proportion to the business transacted there. (***Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal***, 12 AD3d 112, 784 NYS2d 178, ***lv denied*** 4 NY3d 709, 797 NYS2d 421.)

S. Finally, at the conclusion of the hearing in this matter on April 4, 2005, the Division raised an objection to the Administrative Law Judge's refusal to allow additional surrebuttal testimony:

> MR. PETERSON: We have no more questions. We are done, other than we would like to have noted for the record, Judge Pinto, that the Division had indicated at the end of Dr. Silva's testimony on February 18th that we reserved the right to bring him back for surrebuttal, and since then it has been indicated to us that is not possible.
>
> JUDGE PINTO: That is correct. On March 4th I wrote a letter to the parties in which I said, after considering the testimony and evidence that had been produced during the 30 plus hours of hearing held between February 15 and 18, I decided to only permit rebuttal by the petitioner in this case.

You bring up a good point, though. There really is no provision in our regulations for endless surrebuttal and in the interest of closure in this particular case I felt it was adequate to draw the line here.

I just want to mention in coming to that conclusion the length of the audit that took place here, the time the Division had the KPMG report during that time period, during the audit, the two expert opinions that were presented by the Division here, the reports, the rebuttal reports, two full days of testimony by the experts, five affidavits introduced today by one of your experts both clarifying and edifying testimony, as well as having your expert here to assist you in cross-examination, I thought and feel even more strongly now that was the proper ruling in this matter.

Do the sides - - having said that, I will note your statement for the record.

MR. PETERSON: Thank you, Judge.

The State Administrative Procedure Act and the Rules of Practice and Procedure of the Tax Appeals Tribunal give presiding officers the authority to regulate the course of hearings. (SAPA § 304[4]; ***see also***, 20 NYCRR 3000.15[c].) This is done in a manner which gives meaning to the purpose of the Division of Tax Appeals: to provide the public with a just system of resolving controversies with the Division of Taxation and ensuring that the elements of due process are present in such matters. (Tax Law § 2000.) Given all the facts and circumstances of this matter, there is no question that the Division received its full measure of fairness and the ruling on the objection at hearing, confirming the contents of the letter to the parties, dated March 4, 2005, was correct.

T. The petition of Hallmark Marketing Corporation is granted and the Notice of Deficiency, dated February 13, 2004, is cancelled.

DATED: Troy, New York
January 26, 2006

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE