STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
KNOWLEDGE LEARNING CORPORATION AND KINDERCARE LEARNING CENTERS, INC.	:	DETERMINATION DTA NOS. 823962 AND 823963
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Periods ended December 31, 2005, December 30, 2006 and December 29, 2007.	:	

Petitioners, Knowledge Learning Corporation and Kindercare Learning Centers, Inc., each 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 periods ended December 31, 2005, December 30, 2006 and December 29, 2007.

A hearing was commenced before Donna M. Gardiner, Administrative Law Judge, in New York, New York, on May 31, 2012 at 10:00 A.M., and was continued to conclusion at the same location on June 1, 2012, with all briefs to be submitted by October 1, 2012, which date commenced the six-month period for issuance of this determination. By a letter dated February 26, 2013, this six-month period was extended for an additional three months (Tax Law § 2010[3]). Petitioners appeared by WTAS, LLC (Kenneth T. Zemsky, Esq., and Raymond J. Frieda, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel).

ISSUES

I. Whether substantial intercorporate transactions exist between Knowledge Learning Corporation and Kindercare Learning Centers, Inc., and between Knowledge Learning Corporation and the other includable affiliates, which mandates combined reporting for the 2007 taxable year.

II. Whether the Metropolitan Commuter Transportation District surcharge property factor should be based on actual asset values rather than on the number of site locations.

III. Whether Kindercare Learning Centers, Inc., is entitled to a net operating loss deduction.

FINDINGS OF FACT

1. Knowledge Learning Corporation (KLC) was incorporated in 1986 and began doing business in New York in 1994. KLC operates pre-K learning centers and after-school care for children ages six weeks to twelve years. During the audit years, KLC operated between 11 and 19 child care centers in New York.

2. Kindercare Learning Centers, Inc. (Kindercare) was incorporated in 1986 and began doing business in New York in 1988. Kindercare operates child day care centers and before and after-school programs for children ages six months to twelve years. Kindercare operated nine centers in New York, six of which were located in the Metropolitan Commuter Transportation District (MCTD).

3. KLC purchased Kindercare in January of 2005.

4. For the tax periods ended December 31, 2005 and December 30, 2006, petitioners filed separate franchise tax returns in New York.

5. For the tax period ended December 29, 2007, KLC filed a combined franchise tax return with Kindercare and certain other affiliates.

6. The Division of Taxation (Division) conducted an audit of petitioners' separate filings for the tax periods ended December 31, 2005 and December 30, 2006 and petitioners' combined filing for the tax period ended December 29, 2007. After the 2007 returns were filed, KLC was notified by the Division that it would be auditing the taxable years 2005, 2006 and 2007.

7. The audit commenced with a field trip to KLC's offices on July 16, 2009. Three days later, the audit team held an exit conference with petitioner and notified KLC that the combined filing for 2007 appeared to be in error and would likely not be accepted by the Division. At the conclusion of the exit conference, the auditor gave KLC an information document request (IDR 1). The IDR requested information to substantiate that the requirements were met in order for the combined report to be accepted, including copies of any intercompany agreements or arrangements, a detailed explanation of all intercompany transactions, detail of income and expense accounts for all intercompany transactions, and journal entries for all intercompany transactions.

8. KLC did not memorialize any of the intercompany agreements with formal contracts.

9. Exhibit O is the audit work file for KLC. Included in this exhibit is petitioners' response to IDR 1. Under the heading "Company Relationships," petitioners described their cash transactions. Specifically, it states:

> In the wake of the KinderCare acquisition, cash has been concentrated at Knowledge Learning Corporation; modest balances appear on the trial balances of subsidiaries but these amounts are swept to the parent's account. This was achieved January 1, 2006 (footnote omitted). As a result, receipts of the subsidiaries post through the companies' intercompany accounts. All payments of expenses for all legal entities are paid by Knowledge Learning Corporation.

10. Petitioners also provided spreadsheets claiming to detail the intercompany transactions between KLC and its affiliates, including Kindercare. The spreadsheets contain separate columns for "Form 1120 Deduction," "Shared Service Allocation," and "Total Costs Purchased Through Knowledge Learning Corp." For the tax period ended December 29, 2007, Kindercare showed a total of $588,514,844.00 under "Form 1120 Deduction," a total of $66,829,978.00 under "Shared Service Allocation," and a total of $655,344,822.00 under "Total Costs Purchased Through Knowledge Learning Corp."

11. Petitioners provided a disc containing more than 1.8 million lines of activity posting to intercompany accounts. Under the heading "Intercompany transaction journal entries," the IDR 1 response states that all cash accounts for all activities are concentrated in KLC's name. Literally, every time that a cash transaction is posted for a subsidiary, an intercompany journal entry is recorded. The IDR 1 response sets forth certain examples of how this is accomplished.

12. Based upon petitioners' explanation of the cash transactions, intercompany transactions, and intercompany journal entries, the Division determined that KLC paid Kindercare's expenses with Kindercare's cash.

13. For the tax period ended December 29, 2007, KLC recognized a $57.6 million loss for federal income tax purposes on an as-if separately filed basis. The Division determined that the result of combing KLC and Kindercare for New York tax purposes was that KLC's $57.6 million loss was used to offset part of Kindercare's $109.3 million of income.

14. Based on the information provided during the audit, the Division determined that petitioners did not provide adequate evidence to support substantial intercorporate transactions between KLC and Kindercare or KLC and its other affiliates and that petitioners' income and expenses were properly reflected on a separate basis.

15. The Division also made other minor adjustments to petitioners' tax filings for the audit years unrelated to combination. The first adjustment dealt with the MCTD surcharge. Specifically, the auditor changed the property factor to apportion liability within the surcharge district based upon the number of locations that the company had in New York to number of total locations. The second adjustment dealt with disallowance of net operating losses (NOL).

16. As a result of the audit, the Division issued Notice of Deficiency #L-034441018, dated August 5, 2010, to Knowledge Learning Corporation, and Notice of Deficiency #L-034441579, dated August 5, 2010, to Kindercare Learning Centers, Inc., for the periods ending December 31, 2005, December 30, 2006 and December 29, 2007. Petitioners each filed a petition contesting the notices.

17. At the formal hearing, petitioners presented the testimony of Wendy Hamel, Lynette Alexander and David Benedict. Ms. Hamel was employed by Knowledge Universe, LLC (formerly known as KLC) as the income tax manager at the time of the hearing. She had been in that position for about four years. Ms. Hamel's duties include reviewing tax returns, preparing the accounting for income taxes and being the primary contact for the auditors.

18. Ms. Hamel testified that in addition to Kindercare, KLC's affiliated group included Mulberry Child Care Centers, KC Distance Learning, Children's Creative Learning Centers and Science Enrichment Services. According to Ms. Hamel, all of the employees of these companies were brought on the payroll of KLC in January 2006. Ms. Hamel was hired by KLC in July 2006. Ms. Hamel further testified that KLC hired, fired and supervised the employees.

19. Ms. Hamel testified that a memo was distributed to employees explaining that the employees were or would be employees of KLC at a date certain. Ms. Hamel also testified that the duties, obligations and daily activities of the employees did not change as a result of the

transfer. Ms. Hamel was not aware of any employment contracts before the transfer of the employees and she testified that no written contracts were in existence to memorialize the transfer of the employees to KLC.

20. Ms. Hamel testified that Kindercare reported $5,079,690.00 in New York wages and $386,416,398.00 in everywhere wages (for a payroll factor of 1.3146 %) on its franchise tax return for the tax period ended December 30, 2006 even though all employees were transferred on January 1, 2006.

21. Ms. Hamel testified that KLC did not report income from leasing employees to Kindercare. There were no agreements memorializing any intercompany services between the affiliates, except for a master intercompany lease. Ms. Hamel indicated that the duties, obligations and daily activities of the employees did not change after the transfer to KLC.

22. Lynette Alexander was employed by Knowledge Universe at the time of the hearing as the divisional director of operations. Before that, Ms. Alexander had been the regional director of operations since November 2005. Ms. Alexander's duties include supporting center operations and training center directors and district managers. Ms. Alexander was not employed by any of the affiliates at the time KLC purchased Kindercare.

23. Ms. Alexander testified that in 2006, Kindercare and Mulberry employees, among others, were notified by memo that they were all transferred to KLC. She further testified that her paycheck was issued by KLC as well as her Form W-2. Ms. Alexander stated that KLC handled all workers' compensation issues.

24. According to Ms. Alexander, in 2007, KLC employees were responsible for preparing the curriculum used by Kindercare and Mulberry, implementing risk management policies for all companies, handling transportation issues, dealing with regulatory authorities, collecting tuition,

handling communications and handling warehousing and procurement functions.

25. Ms. Alexander testified that the primary business of both KLC and Kindercare was the provision of child learning services.

26. David Benedicts was employed by Knowledge Universe Education at the time of the hearing as Vice President Tax and Risk. Mr. Benedict was hired by Kindercare in January 1998 and transferred to KLC when KLC acquired Kindercare in January of 2005. Mr. Benedict's duties include providing oversight to the risk management function and running the tax function. Mr. Benedict performed the same duties at KLC as he had while working for Kindercare.

27. Mr. Benedict testified that KLC acquired Arrowmark Educational Resources in 2003. KLC acquired Ed Solutions in 2004. Sometime in the early 2000s, KLC acquired Science Enrichment Services. KLC acquired Kindercare in 2005 and Children's Creative Learning Center in 2007.

28. Mr. Benedict stated that employees of all the legacy companies became employees of KLC and that there was no legal evidence of this transfer of employees from Kindercare to KLC. Mr. Benedict testified that, in 2007, almost all of the legacy learning centers were converted to Kindercare learning centers as a result of a rebranding study dated September 2005.

29. It was through Mr. Benedict's testimony that a memo dated November 14, 2005 was submitted into evidence. It is this memo that petitioners rely upon as showing the transfer of employees to KLC. Mr. Benedict testified that KLC adopted a common policy manual, a common code of ethics, a common employee handbook and a common employee benefits handbook.

30. Mr. Benedict testified that petitioners received a benefit in New York by filing on a combined basis in 2007.

31. The Division submitted proposed findings of fact numbered 1-44. Proposed findings of fact 1-12, 15-21 and 25-38 have been incorporated, in substance, in these findings of fact. Proposed findings of fact 13-14, 22-24 and 39-44 have been modified and, as modified, are incorporated herein.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law § 209[1]). The franchise tax is based on the taxpayer's entire net income (ENI). ENI is generally the same as the taxpayer's federal taxable income with certain modifications, and consists of two components, business income and investment income. Business income is equal to ENI less investment income (Tax Law § 208[8]), and is allocated to New York State by multiplying the taxpayer's business income by its business allocation percentage (BAP) as defined in Tax Law § 210(3)(a).

B. Prior to 2007, in order to properly reflect a taxpayer's franchise tax liability, Tax Law former § 211(4) gave the Division the discretion to require or permit corporations subject to New York State franchise tax to file combined reports with certain other corporations. The statute required that the taxpayer either own or control substantially all of the stock of the other corporations, or the taxpayer's stock be substantially owned or controlled by such other corporations. The statute further limited the Division's discretion by providing that

no combined report covering any corporation not a taxpayer shall be required unless the Division deemed such a report necessary, because of intercompany transactions, in order to properly reflect the tax liability (***see*** Tax Law former § 211[4]).

C. In 2007, paragraph 4 of section 211 of the Tax Law was amended to provide that a

combined report is required for corporations engaged in a unitary business where the capital stock and substantial intercorporate transactions requirements are met, in pertinent part, such section provides that:

> [a]ny 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 which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, (hereinafter referred to in this paragraph as "related corporations"), shall make a combined report covering any related corporations if there are substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions. . . (Tax Law § 211[4][a]; ***see*** L 2007, ch 60).

To determine whether substantial intercorporate transactions exist, the statute further provides as follows:

> the commissioner shall consider and evaluate all activities and transactions of the taxpayer and its related corporations. Activities and transactions that will be considered include, but are not limited to:
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> (i) manufacturing, acquiring goods or property, or performing services, for related corporations; (ii) selling goods acquired from related corporations; (iii) financing sales of related corporations; (iv) performing related customer services using common facilities and employees for related corporations; (v) incurring expenses that benefit, directly or indirectly, one or more related corporations, and (vi) transferring assets, including such assets as accounts receivable, patents or trademarks from one or more related corporations (Tax Law § 211[4][a]).

The Division issued guidance on the amendment to section 211(4) (TSB-M-08[2]C), which explained intercorporate receipts, intercorporate expenditures and intercorporate transfers of assets constitute intercorporate transactions:

> Substantial intercorporate receipts
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> The substantial intercorporate transactions requirement will be satisfied when, during the taxable year, 50% or more of a corporations's receipts included in the computation of entire net income (excluding nonrecurring items) are from one or more related corporations. However, if a corporation's receipts (excluding

> nonrecurring items) from one or more related corporations are between 45% and 55%, the multi-year test . . . applies.
>
> Substantial intercorporate expenditures
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> The substantial intercorporate transactions requirement will be met when, during the taxable year, 50% or more of a corporation's expenditures included in the computation of entire net income, including for inventory (but excluding nonrecurring items), are from one or more related corporations. However, if a corporation's expenditures, including for inventory (but excluding recurring items), from one or more related corporations are between 45% and 55%, the multi-year test . . . applies.
>
> Expenditures incurred by a corporation that directly or indirectly benefit a related corporation can constitute substantial intercorporate transactions. For example, when a related corporation is incurring expenditures that benefit another related corporation and the amount of those expenditures represent 50% or more of the expenditures of the first corporation or are equal to 50% or more of the direct and indirect expenditures of the beneficiary corporation, the substantial intercorporate transactions requirement is satisfied.
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> Substantial intercorporate asset transfers
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> A transfer of assets to a related corporation (including through incorporation) will satisfy the substantial intercorporate transactions requirement where 20% or more of the transferee's gross income, including any dividends received, is derived directly from the transferred assets and the corporations are engaged in a unitary business. Only those assets that are transferred to the transferee in exchange for stock or paid-in capital of the transferee are taken into account for purposes of the substantial intercorporate asset transfer test . . . (TSB-M-08[2]C).

This memorandum, in conjunction with the Division's regulations at 20 NYCRR 6-2.3(c), provides that service functions like accounting, legal and personnel services are not to be considered when determining whether substantial intercorporate transactions exist when such services are incidental to the business of the corporation providing such service.

D. Therefore, under the current law, where there are substantial intercorporate transactions, a combined report is required. However, petitioners have failed to demonstrate that substantial intercorporate transactions existed.

Initially, petitioners claim that the only personnel of the KLC affiliated group were KLC employees. All of petitioners' witnesses testified that, in their mind, there was no question that all affiliated groups' employees were transferred to KLC on January 1, 2006. However, as the Division points out, there are no written agreements effecting the transfer of Kindercare employees to KLC. I find a lack of any documentation effecting such transfer to be weighed heavily against petitioners on this issue.

In support of their argument that there was a transfer of employees, petitioners introduced a one page memo that was dated November 14, 2005. In reviewing the memo, it is noted that it is not addressed to anyone in particular. The memo discusses the growth of KLC and what benefits are expected. The memo states, in pertinent part, as follows:

> As part of the Knowledge Learning Corporation (KLC) team, you have made the commitment to do something worthwhile and rewarding to enrich your life and the lives of many children. We are just as committed to providing you with a challenging, rewarding work environment, marked by a new benefits program that is designed to grow with you as we grow together as a company (Exhibit 10).

The memo outlines certain anticipated employee benefits. Clearly, this memo does not demonstrate any transfer of employees to KLC. Petitioners simply cannot meet their burden of proof on this issue by relying on the testimony of their witnesses. Each witness stated that a transfer of employees took place, yet no witness could provide any detail on the transfer of employees rather than to rely on the memo discussed above.

Petitioners claim that substantial intercorporate transactions do exist because KLC pays all of the expenses of Kindercare. However, upon looking more closely at the accounts, it appears that KLC is merely paying expenses on behalf of Kindercare using Kindercare's own cash to do so. All of Kindercare's cash is swept into KLC's cash concentration account. This results in multiple intercompany journal entries to show that Kindercare's cash in KLC's account is used to

pay Kindercare's expenses. These journal entries as set forth on the CD would not be necessary if Kindercare paid its own expenses from its own accounts. In reviewing the tax returns of Kindercare, they reflect that Kindercare incurred these expenses and properly deducted them. The sheer volume of transactions appear to be nothing more than accounting entries and, as such, are not considered transactions for purposes of the substantial intercorporate transactions.

Additionally, in determining whether substantial intercorporate transactions exist, the Division will consider, in pertinent part, the following:

> the materiality of the transactions and whether the transactions have economic substance, including the extent to which the motivation of the taxpayer in undertaking the transactions was to affect the membership of the combined group (TSB-M-8[2]C, p. 5).

As the Division correctly notes, the duties, obligations and daily activities of the employees did not change as a result of their being transferred to KLC. Although this case is one of first impression under the amended statute, the Tax Appeals Tribunal has dealt with the issue of valid business purpose and whether a transaction has economic substance (***see Matter of The Sherwin-Williams Co.***, Tax Appeals Tribunal, June 5, 2003, ***confirmed*** 12 AD3d 112 [3d Dept 2004] [wherein the transfer and lease back of its trademarks had no valid business purpose and lacked economic substance]; ***see also Matter of Talbots, Inc.***, Tax Appeals Tribunal, September 8, 2008). Therefore, petitioners have failed to show that substantial intercorporate transactions exist such that a combined report would be required under the law.[1]

E. The next issue to address is whether the Division's adjustment to KLC's MCTD surcharge was appropriate. The Division adjusted the MCTD surcharge by applying a ratio based

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[1]Petitioners advanced an alternative argument in their brief claiming an entitlement to file a combined report in order to avoid distortion under the prior statutory framework. Since it has been determined that distortion is not the proper analysis in light of the 2007 statutory amendment, such argument need not be addressed herein.

on the number of locations that petitioner maintained within the surcharge district to total number of sites maintained within New York State. Tax Law § 209-B(2)(a) provides that the appropriate apportionment factor should be based on the value of actual property, owned and leased, within and without the surcharge district.

During the hearing, the auditor was questioned repeatedly on this issue, specifically, to determine why the Division did not use the values provided by petitioner. The auditor did concede that the method set forth in the statute was preferable to the method used by the Division; however, given the time constraints on completing the audit versus the lack of substantiation of the values provided to the Division, the auditor explained that, in his opinion, the Division used the correct ratio. Given that petitioner did not substantiate the values that it sought to use here, I find that there has been no demonstration that the Division's ratio was inappropriate.

F. The last issue involves whether Kindercare is entitled to net operating loss deductions. In my review of the record, it appears that Kindercare never claimed a net operating loss. The Division did, in fact, deny KLC's net operating loss for the tax period ended December 9, 2007, based on the fact that KLC had a federal loss in that period on a separate basis. Therefore, petitioner has failed to demonstrate an entitlement to a net operating loss herein.

G. The petitions of Knowledge Learning Corporation and Kindercare Learning Centers, Inc. are denied and the Notices of Deficiency are sustained.

DATED: Albany, New York
June 27, 2013

/s/ Donna M. Gardiner
ADMINISTRATIVE LAW JUDGE