REPORT # 590

TAX SECTION

New York State Bar Association

Report on Combined Reporting for
New York Corporate Franchise Tax Purposes

by the Committee on New York State Tax Matters

October 14, 1988

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TAX SECTION
New York State Bar Association

October 14, 1988

Hon. James W. Wetzler
Commissioner of Taxation and Finance
State Campus - Building #9
Albany, NY 12227

Dear Commissioner Wetzler:

The Tax Section has produced the enclosed report to assist the Department of Taxation and Finance with its current study of combined reporting for corporate franchise tax purposes.

The report surveys the background of combined reporting in New York, sets forth the current problems, and analyzes various alternative solutions.

In summary, the Tax Section recommends that serious consideration be given to a voluntary combination approach, based on a federal consolidated return criterion, with the Commissioner retaining his section 211.5 authority to rectify any distortions. If, after study, that approach is not adopted, we recommend pursuing an approach whereby combination can be required only if distortion exists and cannot be cured by section 211.5 adjustments.

As always, we are available to answer any questions, discuss any alternatives, and help in any way possible.

Sincerely,

Herbert L. Camp

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NEW YORK STATE BAR ASSOCIATION
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COMMITTEE ON NEW YORK STATE TAX MATTERS

Combined Reporting for New York Corporate Franchise Tax Purposes[*]

October 14, 1988

The New York Tax Law authorizes the Commissioner of Taxation and Finance to exercise discretion in requiring or permitting closely related corporations to file combined franchise tax reports.[1/] Although the statute offers some guidance regarding the limits within which the Commissioner may exercise discretion, there remain broad areas in which the extent of the Commissioner's and taxpayers' rights are unclear. The Regulations and the case law are inconsistent and have not clarified the situation.

As a result, the Legislature in 1987 directed the Department of Taxation and Finance to perform a study relating to the requirements for, and the effects of, combined reporting.[2/] This report has been prepared to assist in the preparation and review of the Department's study. While this report suggests that serious consideration be given to one approach, it recognizes that fiscal requirements

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[*] This report was prepared by Peter L. Faber, Edward M. Griffith, Jr., and Arthur R. Rosen. Helpful comments were provided by James A. Locke and Hugh T. McCormick.

may dictate the adoption of another approach.*

I. Background

Combined reporting is the tax accounting practice whereby separate corporations are effectively treated as one entity for state franchise tax or income tax purposes. Once the income or capital of the combined group has been determined, a portion is apportioned or allocated to the taxing state according to factors relating to the combined group's presence within the state. This practice has been approved by the U.S. Supreme Court.[3/]

A state combined report is different from a federal consolidated return. The objective of combined reporting is to determine the portion of the group's combined income that is attributable to activities in the taxing state of those entities that are taxable in that state; each taxable entity is then jointly and severally liable for the combined tax due. The objective of the consolidated return is to determine the overall tax liability of the entire group.

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* This report focuses on the issue of what circumstances should lead to combined reporting under Article 9-A of the Tax Law, applicable to business corporations in general; issues such as the computation of tax liability in a combined report and the combining of specific types of corporations taxable under Articles other than 9-A are not addressed.

Combined reporting has generated a great deal of litigation, publicity, and political activity throughout the United States during the past several years. The major issues that have plagued taxpayers in states other than New York have been the inclusion under unitary reporting rules of foreign (non-U.S.) corporations and foreign dividends in combined reports and the lack of clear guidelines relating to when taxpayers will be permitted or required to file combined reports.

II. History of New York Combined Reporting

The predecessor of section 211.4 was added to the Tax Law by Chapter 640, Laws of 1920, as section 211.9. It provided that, in situations where both a parent and a subsidiary corporation were required to file a report under the statute, the Tax Commission could require them to file a consolidated report to show their “combined entire net income”.

In People ex rel. Studebaker Corporation v. Gilchrist, 244 N.Y. 114 (l926), the court, in a situation involving non-arm's-length transactions between a parent and subsidiary, held that section 211.9 did not allow the Tax Commission to require a consolidated report where one of the related corporations was not otherwise required to file a franchise tax return.

Chapter 322, Laws of 1925, deleted the requirement that each of the related corporations be subject to the franchise tax but limited the Tax Commission's authority to require consolidated reports with nontaxpayers to those situations in which an “arrangement exists in such manner as to improperly reflect” the taxpayer corporation's net income.

The next relevant amendment was made by Chapter 415, Laws of 1944, which, in effect, separated former section 211.9 into sections 211.4 and 211.5. Other than for later amendments to section 211.4 which are not relevant to this report, sections 211.4 and 211.5 remain in substantially the same form.

The legislative history of these provisions is minimal.[4/] However, comments by Carter J. Louthan, an attorney member of the Governor's advisory group (whose charge was to recommend changes to overhaul the corporate business tax), published in the Proceedings of New York University 1945 Conference, make it clear that the combined report provisions were intended to be used to prevent and rectify distortions of income:

> “If the course of dealings is determined to show a distortion of income or capital, the Commission then is in a position to adopt either of two courses.
>
> The Tax Commission may content itself with making adjustments which will give the New York taxpayer the net income it ordinarily would have had if it had been dealing with outsiders at arm's length.
>
> However, if the Tax Commission deems it necessary to properly reflect the tax, it may require the New York taxpayer to file a consolidated report reflecting the income and capital of both the New York taxpayer and the foreign corporation with whom there was the improper understanding or agreement which resulted in the distortion of income.
>
> Where the parent manufactures in another State and the subsidiary buys from the parent and sells for

> its own account in New York, the question of course arises as to whether the subsidiary is making a fair profit from the transactions. If the subsidiary is making a fair profit, the Tax Commission has no power to adjust its income and it is submitted that it should not force the filing of a consolidated report." [Emphasis added.]

In addition, another contributor to the Proceedings, Ellis J. Staley, Jr., Legal Assistant to the Commissioner of the Department of Taxation and Finance, stated:

> "Also, where under similar circum- stances a taxpayer has entered into an agreement or transaction with an affiliated corporation at more or less than fair prices so as to create an improper loss or net income, the Tax Commission may include in the entire net income of the taxpayer the fair profits which but for such agreement or understanding the taxpayer might have derived from such transaction. The mere existence of the provisions of this subdivision seems to have been sufficient in the past to prevent the practices which its terms are intended to correct, and therefore the authority granted has been invoked in very rare cases. However, where affiliated corporations were discovered to be indulging in such practices, the method that would be used for the correction of the distortion would be the requirement of a consolidated report for such corporations. The provisions of the present law covering this problem are identical, in substance at least, with the provisions of former Article 9-A and it is under this situation that the Tax Commission still retains the authority and power to require a foreign corporation not subject to tax within the State to be included in the consolidated report where it is established that such foreign corporation has participated with a taxpayer for the purpose of distorting income taxable within New York by indulging in such profit diverting devices. "[5/] [Emphasis added.]

Apparently, the device of combined reporting was to be used as both a threat to prevent distortion and as a cure when actual distortion existed. There is no indication that certain business arrangements were to be assumed to be distortive.

III. Current Law and Regulations

The Tax Law simply states that if there is direct or indirect common ownership of "substantially all the capital stock" of more than one corporation, the corporations may be required or permitted to file a combined report. A combined report including a corporation that is not a taxpayer may be required only when the Commissioner of Taxation and Finance "deems such a report necessary, because of intercompany transactions or some agreement, understanding, arrangement or transaction"[6/] that results in "the activity, business, income or capital of the taxpayer within the state [being] improperly or inaccurately reflected."[7/] In sum, once there is substantial common ownership, the statute gives the Commissioner unguided discretion to permit or deny combined reporting among taxpayer corporations, unguided discretion to permit or deny combined reporting among taxpayers and nontaxpayer corporations, and unguided discretion to require combined reporting among taxpayer corporations. Only when the Commissioner attempts to require combined reporting to include a nontaxpayer corporation is he constrained to find that separate reporting would be improper.

The current regulations,[8/] adopted by the State Tax Commission in 1983, provide that a combined report will be permitted or required of taxpayer corporations if:

(1) substantially all of the capital stock of two or more corporations is owned or controlled by the same interests;
(2) the corporations are engaged in a unitary business; and

(3) reporting on a separate basis would distort the taxpayer's New York activities, business, income or capital.

With respect to requiring a nontaxpayer corporation's inclusion in a combined report against its wishes, the stock ownership and unitary business requirements ((1) and (2) above) must be satisfied, the distortion test ((3) above) need not be satisfied, but the inclusion of the nontaxpayer corporation must be necessary to properly reflect the taxpayer corporation's tax liability because of substantial intercorporate transactions or an agreement or arrangement that results in improper or inaccurate reflection of the taxpayer's activity, business, income, loss or capital within New York.[9/] As will be discussed later, no clear distinction has been made between this requirement and the distortion requirement ((3)above).

The case law does not deviate from the Regulations' interpretation of the statute's stock ownership criterion, although there are many areas of uncertainty. The regulations' unitary business criterion has no statutory basis other than as an exercise of the Commissioner's discretion; the case law, however, has stressed the direct relationship between the existence of a unitary business and the propriety of combined reporting. The statute only requires the Commissioner to find one type of “distortion” before requiring a nontaxpayer corporation to be included in a combined report; the Regulations repeat this and add the requirement of a possibly different type or degree of distortion; it is arguable, however, that under the case law any distortion criterion has been subsumed by the unitary criterion.

A. The Regulations' Stock Ownership Requirement

The Tax Law requires that substantially all of the capital stock of corporations that are being combined be directly or indirectly owned or controlled by common interests.

The Regulations provide that “substantially all” means ownership or control of 80 percent or more of the voting stock. Ownership includes both actual and beneficial ownership; to be considered the owner, the shareholder must have the right to vote and the right to receive dividends. Control, which is to be determined by the facts in each case, refers to all cases where the taxpayer controls the stock of all other corporations, or the stock of the taxpayer is controlled by other corporations, or the taxpayer and the other corporations are controlled by the same “interests”.

Although there evidently has been very little controversy regarding the ownership requirement for New York franchise tax purposes, this requirement has caused considerable controversy in other states. Some of the matters that the Regulations do not address but that may cause concern in the future include:

(1) The treatment of contingent voting stock, i.e., stock that can vote if there are dividend arrearages or if certain transactions take place, such as a sale of substantially all of the assets of the corporation.
(2) The treatment of stock with diluted voting right, e.g., where each share has 1/5th of a vote.
(3) The ownership of shares that have been placed in a voting trust.
(4) The ownership of shares under option.
(5) Family attribution.

In addition, under the present Regulations, the ownership or control of voting capital stock is the only test. There is no requirement that the voting capital stock participate in corporate growth. Thus, voting preferred stock would be considered even though it only paid a reasonable rate of dividend and did not otherwise participate in corporate profits. On the other hand, nonvoting common stock that participated fully in corporate growth would not be considered. In contrast, under the federal consolidated return provisions, a consolidated return can be filed if the parent corporation owns at least 80 percent (directly or indirectly) of the voting power and value of the subsidiary corporation, disregarding certain non-voting preferred stock that does not participate in corporate growth.[10/]

Moreover, the reference in the Regulations to voting stock is ambiguous. It is not clear whether it refers to shares of voting stock or voting power. This could be a serious problem with respect to a corporation with several classes of stock with different voting rights where one shareholder could own more shares of voting stock but have less voting power than another shareholder. It would seem that voting power is intended to be the test, particularly in view of the “control” language, but the Regulations could be read literally to mean ownership of shares of voting stock.

Finally, there is no guidance relating to the definition of “interests” that may control multiple corporations so as to permit or require combined reporting. The word “interests” suggests that the holder of common control need not be a corporation. May one corporation whose stock is wholly owned by one individual be combined with another corporation

whose stock is wholly owned by another individual who is closely related to the first individual? Are partners' interests relevant in determining ownership? Can minority interests that are acting merely in concert be joined and deemed a controlling interest?

B. The Regulations' Unitary Business Requirement

The unitary business requirement is not mentioned in the statute. As mentioned, however, the Regulations provide that a combined report will not be permitted or required unless the members of the combined group are engaged in a unitary business.

In determining whether a corporation is part of a unitary business, the Regulations state that the Department will take into account whether the corporation's activities are related to the activities of the other corporations in the group, such as manufacturing goods or performing services for such other corporations, selling goods acquired from them, or financing their sales. In addition, the Department will also consider whether the corporation is engaged in the same or related lines of business as other group members, such as manufacturing or selling similar products, performing similar services, or performing services for the same customers.

The Regulations do not relate the unitary business requirement to the unitary business test developed by the United States Supreme Court in cases establishing the constitutional limits on the application of apportionment formulas to interstate business enterprises. However, it appears that the definition is more inclusive than the definition developed by the Supreme Court which, summarily stated, permits combination when there is a “flow of value” between or among related

entities.[11/] It could not constitutionally be more inclusive in cases involving corporations that are not New York taxpayers and the Regulations do not purport to apply a different definition in such cases.

It is clear under the Regulations that even a corporation conducting a stand-alone business with its own employees and property may still be required to file a combined report with a related corporation. For example, if a manufacturing corporation organizes a subsidiary to which it transfers all of its sales operations and the subsidiary has its own place of business and employees but sells only the parent's products on a commission basis, the two corporations will be deemed to be engaged in a unitary business.

If a holding company's only activity is holding the capital stock of and receiving dividends from subsidiaries, it is not considered to be engaged in a unitary business with its subsidiaries. The Regulations do not address the situation where a holding company performs administrative or management services for its subsidiaries.

C. The Regulations' Distortion Requirement

The Regulations provide that, if the stock ownership and unitary business requirements are satisfied, combined reports, including only taxpayer corporations or both taxpayer and nontaxpayer corporations, will be permitted and combined reports, including only taxpayer corporations, shall be required, only “if reporting on a separate basis distorts the activities, business, income or capital”. A possibly different “distortion” requirement applies to a situation where the

Department requires a nontaxpayer corporation to be included in a combined report.

The activities, business, income, or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis and there are substantial intercorporate transactions among the related corporations. In determining whether there are substantial intercorporate transactions, “transactions directly connected with the business conducted by the corporation” are considered, including (1) manufacturing goods or acquiring property or performing services for other corporations in the group; (2) selling goods acquired from others in the group; (3) financing sales of other group members; or (4) performing related customer services using common facilities and employees.[12/]

Service functions, such as accounting, legal or personnel services, are not considered when they are incidental to the business of the corporation providing the services. The Regulations provide further that the substantial intercorporate transactions test may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities. It is not necessary that there be substantial intercorporate transactions between any one member with every other member of the group; it is sufficient that each corporation has substantial intercorporate transactions with one other combinable corporation or with a combinable group of corporations.

If a corporation meeting the stock ownership requirement does not meet the presumption of distortion because it does not have substantial intercorporate transactions, it nevertheless may be permitted or required to file a combined report if filing

on a separate basis would otherwise result in distortion. Moreover, if it can be shown that distortion does not exist despite the existence of substantial intercorporate transactions, the presumption will be rebutted, and a combined report will not be permitted or required.[13/]

Unfortunately, the Regulations do not define "distortion". It would seem to mean more than just difficulty in accurately stating the financial data of two or more related corporations that have extensive intercompany transactions and relationships. Thus, distortion should only occur when it can be shown that the income, capital, business or activities of the corporations are not accurately stated on a separate basis and not just that it is difficult to state them.

The most common instance of distortion occurs when related corporations do not deal with each other at arms-length and, consequently, one corporationgs income is artificially reduced. The Regulations recognize this in an example in which a parent corporation conducts research for its subsidiaries without charge.[14/] However, the Regulations do not provide the taxpayer with a guide as to how to rebut the presumption of distortion. It should be sufficient for the taxpayer to show that the intercorporate transactions are conducted at arms-length. In any event, if something more than dealing at arms-length is necessary, the Regulations should say so.

D. Other Franchise Taxes

Tax Law Articles 32 and 33 impose a franchise tax on banking corporations and insurance companies, respectively. While their combined reporting provisions are generally similar to those in Article 9-A, relating to general business

corporations, there are distinctions. For example, section l462(f), found in Article 32, provides different treatment for “80%-owned” and “65%-owned” groups.

IV. The Case Law (Court Decisions)

The New York courts, in deciding whether combined reporting is appropriate in various cases, have not focused on the validity or the application of the Regulations. In large measure, the courts have ignored the Regulations, have added to the statutory framework, and have reached conclusions that are generally consistent with the jurisprudence prevailing throughout the country. The courts have seemed to regard the presence of a unitary business as more important than does the Commissioner. Some cases can be read to ignore any distortion requirement, suggesting that distortion is inherent in a unitary business and that there is no need to prove or disprove the existence of distortion.

In the Matter of American International Group, Inc. v. State Tax Commission[15/], the Tax Commission denied AIG and one of its subsidiaries, AICCO, permission to file a combined report. AIG was a holding company conducting insurance and related businesses through several insurance and non-insurance subsidiaries. AICCO, a non-insurance subsidiary, was engaged in insurance premium financing. A substantial portion of the premiums financed by AICCO was paid to AIG's insurance-writing subsidiaries. The insurance writing subsidiaries, however, were not subject to Article 9-A and, thus, could not be included in a combined report with AIG and AICCO, which were subject to tax under Article 9-A. AIG guaranteed third-party loans to AICCO to enable it to finance premiums. AICCO's loan committee included

officers of AIG. AICCO's accounting policies and procedures were determined by AIG. AIG's president appointed the officers of AICCO and determined their salaries. AIG also provided AICCO with many of its day-to-day needs, such as mail, telephone, typing and filing. The court determined that AICCO acted as a department of a unitary business conducted by the entire AIG group, which had substantial intercompany transactions among its members. Accordingly, it found that the Tax Commission had abused its discretion in not allowing a combined return. Thus, the court found a combined return, including AIG and AICCO, to be in order despite the fact that there were no direct transactions between them, other than the provision of management and administrative services.

In Matter of Coleco Industries, Inc. v. State Tax Commission [16/], the Tax Commission had denied Coleco and one of its subsidiaries, Coleco North, permission to file a combined return. Coleco North had taken over the snowmobile aspect of Coleco's business. It purchased the snowmobiles from a Canadian subsidiary of Coleco, and resold them to New York customers. Coleco North had no separate employees or operating assets. It had officers and directors in common with Coleco, and Coleco provided it with legal, accounting and other services. The court found the Tax Commission's determination to be erroneous. It stated that". . . the question is whether, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income . . . "The court went on to find that ". . . Coleco North was nothing more than a corporate shell . . ." and that the absence of intercompany transactions (other than services) between the corporations to be combined was not dispositive.

Matter of Wurlitzer v. State Tax Commission [17], involved a parent corporation, Wurlitzer, and a wholly owned subsidiary finance company, Wurlitzer Acceptance Corporation (WAC). Wurlitzer was doing business in New York and filed franchise tax returns. WAC, on the other hand, was not doing business in New York and did not file franchise tax returns. WAC purchased retail installment receivables from Wurlitzer on a regular basis at predetermined negotiated rates. Wurlitzer performed all collection services for WAC with respect to the receivables and was paid a fee based on collections. Wurlitzer also performed all management services for WAC, such as negotiating with lending banks, and was paid an additional flat monthly fee for these services. WAC had no independent staff of employees which it paid directly. The Department did not claim that any of the transactions between Wurlitzer and WAC were unfair or on other than an arms-length basis.

On review, the Tax Commission determined that WAC was in substance merely the finance department of the unitary business conducted by Wurlitzer, and that the Tax Commission had the authority to require a combined report, including a nontaxpayer corporation, based solely on intercompany transactions. The Tax Commission made no finding that the transactions between Wurlitzer and WAC were on other than an arms-length basis. Indeed, the Tax Commission determined that "Wurlitzer Company submitted information to show that its charge to Wurlitzer Acceptance Corporation for the collection service represents the cost of such service plus a reasonable profit."

On appeal, the Appellate Division took the "finance Department" statement of the Tax Commission one step further. It found that WAC had no separate corporate autonomy, citing such factors as no separate directors, officers, or employees, no

separate real property or personal property, and that Wurlitzer personnel performed all of WAC'S business operations. The Appellate Division concluded that ". . . since WAC had no separate corporate autonomy and its income is derived solely from intercompany transactions with Wurlitzer, such income must be included in Wurlitzer's in order to properly reflect the entire net income of the New York taxpayer..." [Emphasis in original.]

The Court of Appeals, in a four-to-three decision, affirmed the Appellate Division's decision but on different grounds. It set forth WAC'S "paper" characteristics and said that based on that record, ". . . the Commission could properly conclude that separate reports would not accurately reflect the taxable income or the taxable liability."

The court stated further that there is no requirement that transactions between the affiliates be unfair. In other words, even though Wurlitzer's transactions with WAC were on an arms-length basis, a combined report was necessary to properly reflect Wurlitzer's tax liability.

The dissent stated that the purpose of Tax Law sections 211.4 and 211.5 was to prevent distortion of a New York taxpayer's income. Accordingly, a combined report could not be required because there was no finding of distortion.

In the Matter of Campbell Sales Company v. State Tax commission[18/], the Petitioner ("Sales") was a whollyowned subsidiary of a nontaxpayer corporation, Campbell Soup Company ("Soup"). Sales acted as sales representative for Soup and other Soup subsidiaries. All product orders were approved by Soup out of state and the goods were shipped by Soup directly to the

customer. The compensation paid to Sales for representing Soup was governed by an agreement between the parties which generally provided for a payment equal to Sale's expenses plus a percentage of those expenses. This amounted to a sales commission which was found by the Tax Commission to be fair and reasonable and probably more than an arm's-length commission. Sales had a substantial number of its own employees, but certain of its administrative functions were performed by Soup without compensation. Since 1941, Sales had computed its New York franchise tax liability under Article 9-A using a formula agreed upon with the Tax Commission. On audit, the Department proposed tax deficiencies based on the combined net income of Sales, Soup and the other Soup subsidiaries.

The Tax Commission agreed with the Department's audit adjustment. It stated "[wlhere the businesses of corporations are so unified and interassociated (having due regard for their separate corporate existences), a proper reflection of their New York franchise tax liability is impossible without combination."

On appeal, the Supreme Court, Appellate Division, had a different view. Because the intercompany transactions were on more than an arms-length basis favoring the New York taxpayer, the court, in a three-to-two decision, determined that a combined report was not necessary to properly reflect the New York taxpayer's income.

The Court of Appeals, in a six-to-one decision, reversed. Relying on Wurlitzer, the court stated that it was not necessary that the income or the capital of the taxpayer be improperly or inaccurately reflected before a combined report can be required because of intercompany transactions. It further stated:

> "In any event, the State Tax Commission here expressly found that a proper reflection of . . . New York franchise tax liability is impossible without combination. This conclusion is plainly rational [See 20 NYCRR 6-2 (c)]. Petitioner and its related corporations have substantial intercompany transactions which demonstrate that they have a symbiotic relationship to each other and that petitioner is a vital link in the overall enterprise. Moreover, since its inception, petitioner has exclusively solicited sales to Campbell's Soup in 34 states."

Judge Kaye dissented. She said that Wurlitzer should be restricted to its facts and that the effect of the majority's decision was to read the proper-reflection-of-tax-liability requirement out of the statute.

The decision of the Appellate Division in Matter of Standard Manufacturing Company, Inc. v. State Tax Commission can be read as reviving the distortion requirement.[19/] The court acknowledged the necessity of distortion, but dismissed taxpayer's reliance on an I.R.S. section 482 audit to disprove distortion because the audit related to a tax year not at issue in New York. It is important to note, however, that the Appellate Division decision was rendered prior to the Court of Appeals' decision in Campbell Sales; the Court of Appeals subsequent affirmance in Standard Manufacturing was without opinion.

V. The Case Law (State Tax Commission Decisions)

Although the courts have largely ignored the regulations, the State Tax Commission has not, at least in cases relating to the required inclusion of nontaxpayer corporations in a combined report.

Matter of Digital Equipment Corporation[20/] involved a parent corporation, Digital, and certain wholly-owned foreign subsidiaries, including one which conducted its business operations in Puerto Rico and was taxed as a "possessions corporation" under section 936 of the Internal Revenue Code. A possessions corporation cannot be included in a federal consolidated return, and thus, its dealings with its parent, like those of foreign subsidiaries, were subject to scrutiny by the Internal Revenue Service under section 482 of the Code. The parent was based in Massachusetts and its New York activities were limited to sales and servicing of computer equipment. The subsidiary conducted extensive manufacturing operations, operated relatively independently from its parent and had its own employees, manufacturing facilities, benefit and training programs. The Internal Revenue Service conducted an extensive examination of the corporations' tax returns and required substantial adjustments under section 482 of the Internal Revenue Code for the same taxable years that were involved in the New York combination case. The Tax Commission, without any discussion of the integration of the businesses of the corporations, found that "combined reports were not necessary in order to properly reflect Digital's franchise tax liability." It stated that Digital provided evidence of fair pricing for the years under consideration and that the Department had failed to show that the pricing adjustments did not result in arms-length prices. The Tax Commission distinguished its determination in another "possessions corporation" case, Standard Manufacturing Company, Inc., involving section 482 adjustments, on the ground that the I.R.S. audit in that case did not relate to the tax Years before the Tax Commission but to earlier tax years.[21/]

At most, the rule enunciated by the former Tax Commission in Digital will have limited utility. It is normal

for a nontaxpayer corporation that is a candidate for a combined report to be included in a federal consolidated return with its taxpayer affiliates. Absent unusual circumstances, section 482 adjustments are not made to transactions between members of a federal consolidated return because there is no federal tax effect. However, Digital may be important as standing for the proposition that combination will not be compelled where the taxpayer members of the group can accurately compute their New York tax liability and can show that the inclusion of a nontaxpayer corporation is not necessary properly to reflect it.

The Tax Commission reached a similar conclusion in The Lawyers Cooperative Publishing Company[22/]. The taxpayer charged its nontaxpayer subsidiary competitive prices for manufacturing services provided for the subsidiary. Even though the corporations were engaged in a unitary business and there were substantial intercorporate transactions, the Commission concluded that arms-length standards had been respected and that combination was not necessary properly to reflect tax liability. In addition, in Boehringer Inqelheim Pharmaceuticals, Inc.[23/], combination was not required where the dealings between a taxpayer parent and its nontaxpayer subsidiary were conducted pursuant to an agreement that had originally been negotiated by independent parties and that was assumed by the parent and subsidiary. Without any discussion of whether the corporations were engaged in a unitary business or whether there were substantial intercompany transactions, the Tax Commission determined that, in view of the clearly arms-length arrangement between the corporations, combination was not necesary properly to reflect the taxpayer corporation's income.

The cases involving attempts by the Department to compel nontaxpayers to file combined reports can be reconciled

on their facts, although the sweeping language in certain of the cases tends to confuse the area. Combination will be required if the nontaxpayer corporation is a mere. “shell” lacking independent substance. It will also be required where the intercorporate transactions and other relationships are so extensive that it is impossible to separate the corporations financially so as to determine their proper separate tax liabilities. On the other hand, the taxpayer corporation that can prove that its transactions and relationships with its nontaxpayer affiliates are at arm's length and that its separate tax liability can be computed should be in a position to resist combination.

VI. Recormmendation

A. Introduction

There is substantial inconsistency among the Tax Law, the Regulations, and the case law relating to permissible and required filings of combined reports. The State, current taxpayers, and potential taxpayers (corporations considering relocating to or expanding in New York) would be well-served by the adoption of consistent, coherent rules for combined reports. Although this report has focused on combined reporting under Article 9-A, the coments also apply generally to other franchise taxes that are measured by net income.

Any approach to combined reporting raises economic, political, and technical issues. It is imperative that due consideration be given to each issue before an approach is selected by the Legislature and approved by the Governor.

This report addresses only the issue of when corporations should be combined; it is assumed that the current principles of combined reporting computations (e.g., providing for intercompany eliminations, using group allocation factors) will continue to be used.

B. Voluntary Combination

We recommend that serious consideration be given to allowing corporations that file a consolidated federal income tax return to elect to file a combined franchise tax return. This approach, currently followed by Vermont, has the advantage of ease of administration, the benefit of federal guidance, and the allure of being perceived as “pro-business”.

If this approach were adopted, it would be necessary to develop rules relating to subsequent periods in which an electing group of corporations would be required to continue filing on a combined basis. Presumably, each year's combined group would be identical to that year's federal consolidated group. Thus, any change in the consolidated group would be reflected in the combined group. Further, once a group ceased filing a consolidated return, a combined report would no longer be permitted. To ensure that New York would not be disadvantaged by taxpayers electing combination only in those years when lower taxes would result, an election to file on a combined basis would have to be binding for a number of years, subject to changes in the federal consolidated group.

For these corporations (whether or not consolidated for federal purposes) that elect not to file on a combined basis, the Commissioner would need to retain his current broad authority under Tax Law Section 211.5 (comparable to I.R.C.

S482) to adjust items of income, deduction, and capital to reflect income appropriately allocable to New York. This would be the Commissioner's exclusive remedy; required combination would not be permitted.

The voluntary approach would allow taxpayers to reap some benefits, yet would ensure that the state (through the use of section 211.5) would not lose revenue due to corporate structures and transactions that result in inaccurately reported New York income.

C. Combination Based Only on Distortion

If the voluntary approach to combined reporting as set forth above is not fiscally feasible, combined reporting should be required and permitted only when separate reporting results in distortion of New York tax liability that cannot be adequately dealt with under section 211.5. This approach, which is apparently consistent with the legislative intent embodied in the current Tax Law, but not followed by the Regulations and the courts, could be workable if certain modifications to the current system were implemented.

It is clear that the question of who bears the burden of recognizing and proving distortion needs to be addressed.[24/] It would be most equitable and logical for the party that desires to combine corporations to have the burden of proving distortion. The use of presumptions to establish distortion should not be permitted, since such presumptions may lead to an “automatic unitary approach”, as set forth below. Specifically, the presumption in the current Regulations that substantial intercompany transaction s lead to distortion is inappropriate. This presumption is similar to the tax base of income plus

compensation and the disallowance of deductions for certain interest paid to shareholders in that it imposes undesirable tax consequences on an entire class of transactions because of a fear that some transactions in the class may be abusive. Both of these provisions have been recently repealed, apparently in recognition of the fact that using individual audits to redress specific tax transgressions is better than penalizing an entire taxpayer group. Similarly, when intercompany transactions lead to distortion, such distortion can be proved and redressed on an individual basis through the Commissioner either using section 211.5 or, if that is not adequate, requiring combined reporting.

Tax Law section 211.5 provides, in an analog to Internal Revenue Code section 482, that the Commissioner may reallocate tax attributes among related corporations that do not deal with each other at arms-length in order to reflect their proper tax liabilities. Allocations of specific items of income, deduction, and credit is a less drastic approach than forcing corporations to file combined reports. It focuses only on the particular items that distort the taxpayers' liability and does not require a restatement of the corporations' entire tax returns. The Commissioner should be required to attempt to correct distortion by using this technique in the first instance. Compulsory combination should be required only if the section 211.5 approach cannot avoid distortion.

The recently amended Bank Tax (Article 32), as it applies to "65%-owned" groups, may provide some guidance. The test under section 1462 (f) is the same for taxpayer or nontaxpayer inclusion in a combined report: it must be necessary in order to properly reflect the tax liability of the taxpayer corporations because of intercompany transactions or some agreement, understanding, arrangement or transaction which

distorts the activities, business, income or capital of the taxpayer corporations. In addition, this same test applies whether the taxpayer or nontaxpayer is seeking permission to be included in a combined report or whether the Commissioner is seeking to require its inclusion in a combined report.

Further, unlike section 211.5, its Article 9-A counterpart, section 1462(g) states that if “in the determination of the [Commissioner specific adjustments to income or deductions] do not or cannot effectively provide for accurate determination of the tax, the [Commissioner] shall be authorized to require the filing of a combined return by the taxpayer and any other corporations.” Based on this language, it would seem that the Commissioner is under an obligation to attempt to cure distortion between related taxpayers by making specific adjustments to income or deductions before he can require the filing of a combined report. Otherwise, the Commissioner would be in no position to make an informed determination that such adjustments cannot provide for an accurate tax.

Moreover, unlike the Article 9-A regulations, the Article 32 regulations are specific on how the presumption raised by substantial intercorporate transactions can be rebutted. Indeed, the Article 32 regulations state “ [i]f the intercorporate transactions which create a presumption of improper reflection of tax liability are entered into for a fair or arm's length price, then such intercorporate transactions do not result in an improper reflection of tax liability.” No similar statement is made in the Article 9-A regulations.

In any event, the concept of distortion needs to be delineated. The statute should contain guidance regarding what

constitutes distortion. For example: Can distortion exist if all intercompany transactions are at arms' length prices? Does the existence of a captive buyer necessarily mean that there is distortion?

D. Automatic Unitary Combination

One approach that cannot be ignored would be to require all corporations that conduct a unitary enterprise to file a combined report. This approach is generally followed by those states that have adopted the Uniform Division of Income for Tax Purposes. Act ("UDITPA") or have joined in the Multistate Tax Compact. The implicit assumption in this approach is that the economies of scale, the economies of scope, and the general symbiotic nature of unitary businesses make it impossible to determine the appropriate income to be attributed to any particular division, corporate entity, or geographic operation by separate accounting.

This approach would reduce areas of controversy. Combination would no longer be a matter of discretion. Issues relating to distortion would not be relevant. There is significant authority from courts throughout the country regarding what constitutes a unitary business. Some of the most recent New York cases can be read to indicate substantial sympathy with this approach.

This approach would have the economic effect of providing for an objective (albeit arbitrary) distribution of the taxable income of unitary enterprises, whether they be horizontally integrated or vertically integrated businesses.

The choice between worldwide unitary or water's edge unitary would need to be made. Requiring all unitary business units, wherever located, to join in a combined report may at first blush appear conceptually attractive. However, not only is it difficult to translate the apportionment factors from foreign terms into U.S. dollars, it may be inappropriate to assume that the net income being taxed is equivalently attributable to apportionment factors in a vastly different economic system. For example, if manufacturing takes place in a country with low-wage labor but sales take place in the U.S., only a small part of the income would be allocated to the manufacturing country where, arguably, much of the income is generated. In the alternative, rather than combining foreign entities, dividends from those entities could be included in the domestically apportioned business income. This, however, is manifestly unfair since no income is allocated to the foreign factors that helped generate the income. Finally, using worldwide unitary apportionment would cause great domestic and international furor (as is the case with California); New York would appear to be “anti-business.” Thus, if this approach is selected, only water's edge combination should be considered.

The unitary approach is politically controversial, even if it is limited to United States corporations. It would subject to mandatory combination nontaxpayer corporations that deal with their New York affiliates entirely on an arm's length basis and with no distortion of income. This could significantly increase the cost of compliance for affiliated groups and it can be argued that it would be unfair to do this in situations in which it is not necessary to prevent tax avoidance. On the other hand, a unitary regime would make auditing easy for the Tax Department It would not need to worry about whether corporations deal with each other in a distortive manner and could impose combined

reporting as a solution to all possible evils, real and imagined. However, it is generally believed that the Department should not be allowed to force corporations to restate their tax returns unless it is necessary to prevent tax avoidance. Apparently in recognition of the unpopularity of the unitary approach among many corporations, the Department of Taxation and Finance itself argued against this approach in a 1983 report recommending that the State not join the Multistate Tax Commission.[25/]

Opponents of the unitary approach argue that the present regulatory scheme, which makes the existence of a unitary business a prerequisite for combination but which requires an additional showing that combination is necessary to avoid distortion, is fair. Although, as indicated above, the New York State courts have in some instances seemed to ignore the distortion requirement, they could not do so if the requirement were clearly and explicitly added to the statute.

E. Summary

As indicated above, we recommend serious consideration of the voluntary combination approach, and believe that if, after study, it is not adopted, the approach of requiring combination only if there is distortion that cannot be remedied by section 211.5 adjustments should next be pursued.

FOOTNOTES

[1/] Tax Law 5211.4.

[2/] C.817, L.1987, S109(c)

[3/] Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920); Butler Brothers v. McColgan, 315 U.S. 501 (1942).

[4/] "New York Taxes on Business corporations, investment Trusts and Holding Corporations", November 12, 1943; Letter from Commissioner of Taxation and Finance to Governor Dewey recommending approval of Article 9 amendments, March 21, 1944.

[5/] "Proceedings of New York University 1945 Conference on the New York State Franchise Tax on Business Corporations", pp. 65-66 and 55-56.

[6/] Tax Law S211.4

[7/] Tax Law S211.5

[8/] 20 NYCRR 6-2.2, 6-2.3

[9/] 20 NYCRR 56-2.5

[10/] I.R.C. S1504(a).

[11/] Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983); ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); Exxon v. Dept. of Revenue of Wisconsin, 447 U.S. 207 (1980).

[12/] 20 NYCRR 56-2.3 (c)

[13/] 20 NYCRR S6-2.3 (d)

[14/] 20 NYCRR 46-2.3(4) ex. 9

[15/] 89 A.D.2d 687 (1982), aff'd 59 N.Y.2d 832 (1983).

[16/] 92 A.D.2d 1008, aff'd 59 N.Y.2d 994(1983).

[17/] 35 N.Y.2d 100 (1974).

[18/] 68 N.Y.2d 617 (1986); rev'g 111 A.D.2d 995 (1985).

[19/] Standard Manufacturing Company, Inc. v. State Tax Commission, 114 A.D.2d 138, aff'd 69 N.Y.2d 635 (1986).

[20/] TSB-H-85 (29)C (10/14/85).

[21/] Standard Manufacturing Company, Inc. v. State Tax Commission, 114 A.D.2d 138, aff'd 69 N.Y.2d 635 (1986).

[22/] TSB-H-84(8)C (2/3/84).

[23/] TSB-H-86(5)C (4/30/86).

[24/] See Greenwich Mills Company v. State Tax Commission, 120 A.D.2d 98 (1986).

[25/] State of New York, Department of Taxation and Finance, “The Multistate Tax Commission: Should New York State Join?” (June 1983).