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New York Combined Report Cases

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The area of combined corporate tax reports, through which two or more corporations may file what is in many respects an aggregate tax return, remains one of the hottest issues in New York State and City corporate taxation. Corporations that file on a combined basis are among the largest taxpayers and their audits can result in huge tax assessments. The cases can involve companies holding patents, trademarks or copyrights (see, Toys-R-Us,[1] Burnham),[2] combined groups resulting from mergers or acquisitions or multi-state or multinational businesses with hundreds of subsidiaries. Taxpayers and tax practitioners spend time on the question of which companies will be included or excluded from the combined report and many audit hours are spent by tax agents reviewing returns and identifying affiliated companies they wish to include or exclude from the combined report. While the issue of combination is most often settled in the audit stage, the results of litigated cases set the tone for settlements.

In two recent cases the taxpayers lost. One taxpayer fought the State's effort to require a combined return to be filed; the other taxpayer wanted to file on a combined basis and the State successfully required a separate return for each corporation. Both cases turned on the testimony and reports of expert witnesses hired by the taxpayers to examine intercompany transactions.

The requirements for an affiliated company's being permitted or required to be included in a combined return are: (1) that 80% of the stock be directly or indirectly owned or controlled; (2) that the companies be engaged in a unitary business and; (3) if reporting on a separate basis distorts the activities, income or capital in New York.[3]

Tropicana Case

In Matter of Tropicana Products, Sales, Inc., (NYS Tax Appeals Tribunal, decided June 12, 2000), the Tribunal affirmed the State tax agency's position that a combined report was required to properly reflect the activities and income of the group. The Tribunal did not agree with an expert opinion on the arm's-length nature of intercompany transactions. The Tribunal found that there was distortion in the transactions among the group requiring the subsidiaries' inclusion in the combined return.

The Tropicana case involved three companies, Tropicana Products, Inc. ("Parent"), Tropicana Sales, Inc. ("Sales") and Progress Services, Inc. ("PSI"). The Parent, a Delaware corporation owns the "Tropicana" brand name and processes and packages the well-known juice products. It also engages in research and development of its products and provides administrative, personnel, accounting and tax, information systems and other corporate services to its affiliate. Sales is engaged in the wholesale sale and distribution of Parent's juice products. PSI is in the business of processing and selling waste orange peel for cattle feed and an industrial cleaner (called D'limonent). PSI operated exclusively in Florida and got its orange peel free of charge from its Parent. Prior to the commencement of PSI's operations, Parent had disposed of its waste orange peels and incurred a cost to do so.

The State's Division of Taxation sought to have all three companies file together on a combined basis. The taxpayers submitted a report prepared by a major accounting firm attempting to establish the arm's-length nature of the intercompany transactions in order to preclude combination.

The ALJ, citing several Tribunal decisions,[4] applied principles of transfer pricing found in Internal Revenue Code Search7RH482 to the case at hand and found the expert's report flawed. The ALJ based its opinion upon the failure to identify businesses having the same functions as Sales (some of the companies used in the comparison were in the business of distribution but did not have Sales' transportation and marketing functions) and the fact that only 4 of 14 companies identified as comparable were located in the Northeastern U.S., the primary market of Sales. The ALJ also faulted the expert's reliance on two companies that distributed Tropicana products in the Baltimore-Washington D.C. market, noting that the geographic area served was not comparable to Sales' market area. Criticism was also directed at the use of unaudited financial statements and the fact that the expert did not use actual distribution costs. Also, the ALJ found the expert's analysis of the pricing of transactions between PSI and Parent unconvincing.

On appeal, the taxpayers argued that the expert's report was reasonable, accurate and not contradicted by the Department. The Tribunal rejected the taxpayer's arguments and agreed with the ALJ that the shortcomings of the expert's report were sufficient to support the tax agency's requiring a combined report including all of the companies. The Tribunal also agreed with the ALJ that the report failed in its analysis since the companies chosen were not comparable to the taxpayer. The Tribunal sustained the ALJ's holding that the taxpayers had not met their burden of proof that the transactions were arm's-length.

The Tribunal stated, "[a]lthough there is no requirement that the Division [of Taxation] produce an expert to refute the evidence offered by petitioner, given the potential for complexity in cases which involve transfer pricing issues, the Division appears without an expert at its own peril. However, in this matter, the shortfalls of petitioners' analysis were apparent without the assistance of an expert and even though the expert's testimony and report were uncontroverted, we are not bound to accept the expert's ultimate conclusion."

One factor that clearly troubled both the ALJ and the Tribunal was that the expert report was prepared years after the intercompany transactions occurred and was delivered to the attorney for the State shortly before trial. It cannot be said whether a contemporaneous expert's report or a report submitted at the time of the audit with an opportunity for comments by the State resulting in clarifications or modification of the analysis would have led to a different result.

Panavision Case

Subsequent to the Tropicana decision, another combination case was decided by a State ALJ, Panavision, Inc.[5] Panavision involved seven affiliated corporations that filed a combined report but which the Division of Taxation sought to 'decombine' and require the filing of separate corporate tax returns from each of them.

Panavision designs and manufactures motion picture and television cameras. During the years at issue, Panavision was a wholly-owned subsidiary of Lee International Acquisitions which was wholly-owned by Lee Panavision International, Inc. ("LPI"). Panavision had income in the year at issue of $58 million; LPI had losses in that year of almost $44 million (mostly attributable to interest expense including debts incurred to purchase Panavision) and the other five companies in the taxpayer's combined report had a total of about $7.25 million in losses. It is easy to see that Panavision's filing on a separate company basis would result in substantial tax due to the State and a combined report resulted in the use of the other companies' losses to offset Panavision's income.

Once again an expert opinion was solicited by the taxpayer to show that distortion existed in the intercompany transactions. Two bases were advanced in support of such distortion: management services provided by LPI to Panavision and cash earned by Panavision that was transferred to LPI without any interest charge. The Division of Taxation argued that the taxpayers were not engaged in a unitary business and that there was no distortion among the companies and therefore a combined report was not proper.

The ALJ analyzed the expert report and found that the 'hallmarks' of a unitary business were not present; there was an insufficient flow of value between the companies, there was no centralized management and there were no economies of scale.

The ALJ addressed the issue of distortion in the event the Tribunal disagreed with her findings on unitary business. She analyzed the expert report and (as in Tropicana) disagreed with it flawed. First, she dismissed the expert's analysis of the management services concededly provided by LPI to Panavision without charge by saying, "I am convinced that many of the services under review were a duplication of services performed by Panavision by its own management team, a team which led Panavision successfully. Unfortunately, the conclusion requires a look at what was not brought to the hearing and was not provided to [the expert] for the preparation of her report." The ALJ also had the impression that, while the expert had reviewed stacks of documents, she had only been given what the company wanted her to see. "Panavision limited the intercompany transactions that were subject to [the expert's] review." Recognizing the expense incurred by a taxpayer to engage an expert, the ALJ nevertheless criticized the expert report for not reviewing or quantifying each intercompany transaction that proved distortion and for not interviewing all of the staff with knowledge of the services provided. The ALJ also noted that there was little attempt to analyze transactions among the other affiliates which the taxpayer sought to have included in the combined report.

Of greater concern was the ALJ's analysis of the transfer of funds from Panavision to LPI. In a not unusual practice, LPI, the parent company, would 'sweep' the cash accounts of its subsidiaries (including Panavision) and use the cash to pay expenses and invest any excess. The taxpayer claimed these 'sweeps' were intercompany loans on which no interest was paid. The ALJ found that these transfers of cash functioned more closely as constructive dividends than loans. She based this finding on the fact that Panavision had no ability to demand repayment; there was no agreement concerning repayment; the funds were not actually repaid; no interest was charged and nothing was filled in on the line for "loans to stockholders" on the form requesting permission to file on a combined basis. Thus, having found that these transfers were more properly characterized as dividends, the ALJ concluded no interest charge would be appropriate.

Again, in the context of analyzing whether the various corporations were engaged in a unitary business, the ALJ found that loan guarantees and cross collateralization without any charge did not establish a unitary business since those transactions related to an investment rather than an operational function. The specific issue of distortion created by the guarantees and cross collateralization was not clearly addressed by the ALJ and leaves open a major question.

Another issue that appeared in the Panavision case is a variation on the Turbodyne Corp.[6] case. In Turbodyne, the Tribunal held that a combined return could not be permitted if the statute of limitations on assessment had expired for the affiliates sought to be included in the combined group. In Panavision, the taxpayer argued that the statute of limitations on assessment of the other members of the combined group had expired and therefor, the 'decombination' was inappropriate. The Division of Taxation had secured extensions of the time to assess Panavision, but had allowed the period to assess (and make refund claims) expire for the other six corporations that had been included in the combined report. The ALJ stated that "[u]nlike Turbodyne, the Division's assessment was in accordance with the preservation of its right to review the requested combination, and did not in any way prejudice the other corporations."

In view of the fact that four of the other corporations had losses that were used to offset Panavision's income and presumably not taken as carry forwards, it seems questionable that the other corporations were not prejudiced. A taxpayer cannot require the Division of Taxation to extend the time for assessment or refund claims for all affiliates when a combined report is being audited. However, the taxpayers facing audits of combined reports should file protective refund claims or amended returns to at least preserve their rights while the combination case proceeds.

Observations

What can be gleaned from these two cases may be summarized as follows:

1. an expert report on intercompany transactions undertaken at the time the tax return is being prepared is far better than a report done years after the fact;
2. introducing an expert's opinion, even if the tax agency does not submit its own expert analysis, may not be sufficient to convince the Tribunal of the report's conclusions;
3. questions about what records and documents were not reviewed can be just as troubling as what was reviewed and;
4. there will be more cases on combined reports unless and until an alternative system with more objective, concrete standards is adopted.

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[1] Matter of Toys "R" Us-NYTEX, Inc. (NY City ALJ Division decided August 4, 1999), an appeal to the NY City Tax Appeals Tribunal is pending.

[2] Matter of Burnham Corporation, (NYS Div. of Tax Appeals, July 10, 1997).

[3] Tax Law Search7RH211(4); 20 NYCRR Search7RH6-2.2. NYC Admin. Code Search7RH11-605.4; NYC Rules Sec. 11-91.

[4] Matter of Sears, Roebuck & Co., (NYS Tax Tribunal, April 28, 1994); Matter of Campbell Sales Co., (NYS Tax Tribunal, December 2, 1993); Matter of Medtronic, Inc., (NYS Tax Tribunal, September 23, 1993).

[5] Decided July 13, 2000.

[6] NYS Tax Appeals Tribunal decision July 3, 1996; confirmed Matter of Turbodyne Corp. v. Tax Appeals Tribunal, 245 AD2d 976, lv denied 91 NY2d 812.