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# In ‘Bizarro’ Position, State Argues Against Combined Reporting

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The issue of whether a group of related corporations can file separate New York Franchise Tax returns, or whether they need to file on a combined basis (similar to a Federal consolidated tax return), has, over the years, been one of the most frequently litigated corporate tax issues. Virtually all of these cases have involved taxpayers who have sought to file on a separate return basis. The Division of Taxation (the “Division”) typically takes the position that corporate taxpayers should file combined franchise tax returns. The cases generally involve situations where out of state corporations (corporations that either have no nexus to New York or very low apportionment factors) are highly profitable, either due to the profitability of their own operations or because these corporations receive interest, royalties, or other types of payments from related corporations doing business in New York. The Division has argued in these cases that separate return filing distorts the amount of income taxable by New York.

In two recent cases, *IT USA*[1] and *SunGard*,[2] however, it was the Division that argued that corporate taxpayers should not be permitted to file combined returns and the taxpayers who argued that separate filing would be distortive.

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As a result, the cases are reminiscent of the classic episode of the situation comedy Seinfeld, entitled “The Bizarro Jerry.” In the episode, Elaine meets and begins to hang out with a group of men who resemble Jerry, George, and Kramer but behave in the opposite manner (that is, they don’t act like jerks).[3] The episode generates a funny sense of unease as everything you had come to expect is different. A reader of *IT USA* or *SunGard* will experience the same unease as soon as she reaches the Division’s arguments in each case.

*IT USA* concerned a group of companies that distributed and sold a variety of brands of apparel and luxury goods in the United States that their Italian parent company designed and manufactured. Petitioners IT USA, Inc. (“IT USA”) and Manifatture Associate Cashmere USA, Inc. (“MAC”) were both wholly-owned subsidiaries of IT Holding USA, Inc. (“IT Holding”). IT USA and MAC solely employed sales staff. IT Holding had no sales staff, but rather provided administrative and marketing functions for IT USA and MAC, as well as other affiliates. Among other things, on behalf of IT USA and MAC, IT Holding would process orders, manage delivery logistics, handle receivables and collectibles, provide human resources, public relations, and financial controls functions, and even organize fashion shows. Although IT USA and MAC paid management fees to IT Holding for such services, the fees were calculated at cost (that is, IT Holding received no markup). Further, IT USA, MAC, and IT Holding shared a president. The president would unilaterally move funds between the companies using their shared cash management system. Although some intercompany loans were reported for financing accounting and Federal income tax purposes, the loans were not evidenced by a writing. But for cash infusions from IT USA, MAC would have been insolvent.

The corporate franchise tax combined reporting rules have evolved over the last decade (and will change again next year).[4] For the tax years at issue in the cases,[5] the Tax Law and regulations required or permitted corporations to file a combined corporate franchise tax return if (i) there existed a certain level of overlapping ownership between the combined-reporting entities (called the “capital stock requirement”); (ii) the combined-reporting entities comprised a “unitary business”; and (iii) separate reporting would cause a “distortion” to the business, activities, income or capital of the reporting corporation.[6]

As the capital stock requirement was not at issue, the Division only argued that there was a lack of unitary business and that no distortion would occur by separate reporting. The Division focused its attention on trying to show that no distortion existed between the entities. This is where the Division’s arguments become “bizarro.” First, as indicated in finding of fact 39, the Division appeared to argue contrary to its own

regulations. The Division took the position that *all* corporations in the combined group needed to have substantial intercorporate transactions with all other members of the group. The regulations in effect at the time state that although it is "essential that each corporation have substantial intercorporate transactions with one other corporation or with a combined or combinable group of corporations," "it is not necessary that there be substantial intercorporate transactions between any one member with every other member of the group."[7] Second, the Division argued that management fees paid to IT Holding as reimbursement for costs incurred eliminated any such distortion. Third, the Division argued that the taxpayer had not demonstrated that the terms of intercompany loans were better than could be obtained from unrelated third parties. In previous cases the Division has rejected claims that intercompany payments do not result in distortion, particularly in the absence of proof that the payments were at arm's length.[8] More importantly, the Division has almost always argued that even if intercompany transactions are at arm's length, there exists an "inherent distortion" when "the economic relationship between the related entities [is] so seamlessly integrated as to withstand any and all attempts to properly report their individual net incomes at arm's-length."[9]

The Tax Appeals Tribunal, affirming the ALJ, found that IT USA, MAC, and IT Holding may file a combined return, as the corporations met the three requirements stated above. In finding a unitary business, both state regulation and Federal constitutional principles guided the Tribunal. As to state regulation, the Tribunal specifically looked to (i) whether the activities of each corporation related to the activities of the other corporations in the group; and (ii) whether the corporations were engaged in the same line of business. The Tribunal found both to be the case, as IT Holding's activities were in support of IT USA and MAC's activities, and all three companies were in the same line of business: selling Italian clothing.[10] As for constitutional principles, the Tribunal looked to whether there was sufficient "flow of value" between the corporations, specifically "indicia [like] functional integration, centralization of management[,] and economies of scale."[11] The Tribunal found that the common president, administrative and marketing functions, and cash management system met this requirement, and did not respond to the Division's claim about failure to substantiate.

As for distortion, the Tribunal examined the payments and services that went between the corporations. First, the Tribunal stated that transactions between related corporations not at arm's length necessarily cause a distortion. The Tribunal stated that arm's length typically means cost plus markup. This eviscerated the Division's argument that the mere fact that IT USA and MAC paid IT Holding at cost for services is sufficient to eliminate distortion. Second, the Tribunal noted that a unitary business necessarily causes some distortion, so that the unitary business and distortion factors cannot be wholly considered apart. This acknowledgment of the overlap between the factors is not unlike the "inherent distortion" argument that the Division has made before. Carrying on that thread of "inherent distortion," the Tribunal notes that IT USA and MAC simply could not have existed without IT Holding. No corporation can exist with sales people alone—at least some administrative support is needed. Even putting aside arm's-length considerations, separate reporting for these three corporations would be highly distortive.

The Division was more successful in *SunGard*, in which it prevailed in an ALJ determination. *SunGard* concerned a group of dozens of corporations (the "SunGard Group" or the "Group") that provided information technology and related services. The Group had four business segments: Financial Systems ("FS"), Public Sector ("PS"), Higher Education ("HE"), and Availability Services ("AS"). The Group had at least 70 sub-brands and products. One Group member, SunGard Data Systems, Inc. ("SDS"), which was the Group parent for at least one year at issue, provided administrative services to other members at a cost of around $66 million a year. Partway through the years at issue, the Group came under new control as part of a leveraged buyout ("LBO"). As part of the LBO, SDS took on debt in exchange for which it entered into certain covenants. Unlike the petitioners in *IT USA*, the SunGard Group initially filed separate returns, but sought to file amended returns on a combined basis.

The ALJ did not permit the SunGard Group to file a combined return, finding that the corporations failed both the unitary business and distortion factors. As to unitary business, the ALJ found that the four business segments and their numerous sub-brands and products provided diverse offerings. On the flow of value issue, the ALJ stated that the "management oversight" provided here was not that same as "centralized management." With respect to distortion, the ALJ focused on two issues. First, as the Division argued, although SDS took on debt as part of the LBO, neither the debt nor the associated covenants directly impacted any of the lower-tier Group members. Second, the approximately $66 million a year in services SDS provided was too small to cause distortion when spread over 60 to 80 Group members.[12] For these reasons, the ALJ found that that there was no unitary business or distortion.

As noted earlier, the legislative changes to the combined return provisions enacted in 2007 and earlier this year were expected to prevent litigation on whether or not combined returns would be required by eliminating the substantial intercorporate transactions and distortion requirements. It appears, however, that the Division and taxpayers may still decide to litigate the unitary business issue in many cases.

The Division's positions in *IT USA* and *SunGard*, are very difficult to understand and create the impression that the Division takes a "heads I win, tails you lose" approach to combined reporting, requiring it when it is to their benefit, but preventing it when it is not. This litigation strategy may prove to be the Division's folly: Both cases will give future taxpayers the Division's own words as

ammunition against combination. The Division may have a hard time explaining to an ALJ or the Tribunal that it wasn't them arguing, it was their bizarro counterpart.

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[1] IT USA, Inc., DTA Nos. 823780 and 823781 (Tax App. Trib. Apr. 16, 2014).

[2] SunGard Capital Corp., DTA Nos. 823631, 823632, 823680, 824167, and 824256 (Apr. 3, 2014).

[3] For a summary, see http://en.wikipedia.org/wiki/The_Bizarro_Jerry which includes a detailed list of all of the bizarre aspects of the episode.

[4] Effective January 1, 2015, under new provision Tax Law § 210-C (which replaces § 211.4), groups of corporations that reach a certain threshold of common ownership and that act as a unitary business will be required to file a combined return, largely eliminating litigation on these issues.

[5] *IT USA* concerned tax years 2002 through 2004; *SunGard* 2004 through 2006.

[6] *See* 20 N.Y.C.R.R. former 6-2.1, 6-2.2, and former 6.2-3. In 2007, the statute was amended, elaborating the intercorporate transaction requirements and eliminating the distortion requirement.

[7] 20 N.Y.C.R.R. former 6-2.3.

[8] *See* USV Pharmaceutical Corp., DTA. 801050 (Tax App. Trib. July 16, 1992).

[9] Silver King Broadcasting of N.J., Inc., DTA No. 812589 (Tax App. Trib. May 9, 1996).

[10] Compare this to the facts of *SunGard*, discussed *infra*, where petitioners (who were *not* permitted to combine reporting) had four discrete business segments.

[11] The Tribunal quoted its own summary of constitutional principles from *Medtronic, Inc.*, DTA No. 800306 (Tax App. Trib. Sept. 23, 1993). *Medtronic* summarizes two key U.S. Supreme Court decisions on unitary business, *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992) and *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

[12] Compare this to the two combining corporations to which IT Holding provided services.

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