STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
SEARS, ROEBUCK AND CO.	:	DECISION DTA No. 801732
for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended January 31, 1981 and December 31, 1981.	:	

Petitioner Sears, Roebuck and Co., Sears Tower, Department 970, 41st Floor, Chicago, Illinois 60684, and the Division of Taxation filed exceptions to the determination of the Administrative Law Judge issued on January 28, 1993. Petitioner appeared by Morrison & Foerster (Paul H. Frankel and Hollis L. Hyans, Esqs., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy and Patricia Brumbaugh, Esqs., of counsel).

Both petitioner and the Division of Taxation filed briefs on exception. Oral argument was heard on November 10, 1993, which date began the six-month time period for issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner Koenig concurs.

ISSUES

I. Whether the Division of Taxation properly determined that petitioner, Sears, Roebuck and Co., and its wholly-owned subsidiary, Sears Roebuck Acceptance Corporation, were engaged in a unitary business for the purpose of requiring the companies to file a combined report.

II. Whether the Division of Taxation properly required Sears Roebuck Acceptance Corporation to file a franchise tax report on a combined basis with its parent corporation, Sears, Roebuck and Co., for the fiscal years at issue.

III. If combined reporting of Sears, Roebuck and Co. and Sears Roebuck Acceptance Corporation is required, whether the apportionment formula should be adjusted to include (a) Sears Roebuck Acceptance Corporation's intangible property in the property factor; and (b) Sears Roebuck Acceptance Corporation's receipts in the receipts factor.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except that we have deleted facts "45" through "56" which summarize the arguments of each party at hearing before the Administrative Law Judge. We have also modified findings of fact "16," "17," "18," "19," "26" and "39" in response to the exception filed by the Division of Taxation. We have also eliminated finding of fact "31" since it deals with the provisions of California Law, a matter of which we take judicial notice and finding of fact "38" as unnecessary. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

The parties to this matter stipulated and agreed that, for the purpose of this case, certain facts and exhibits may be accepted as truthful information. Where references are made to exhibits, excerpts from such exhibits or the summarization of the contents of the exhibit will be provided in conjunction with the appropriate stipulated fact. The facts so stipulated are as follows:

Sears, Roebuck and Co. ("Sears") is the petitioner in this case. The years involved are the taxable years ended January 31, 1981 and December 31, 1981, and the tax is the New York corporation franchise tax, Article 9-A of the New York Tax Law. The issues in dispute are: (1) whether the Division of Taxation ("Division") of the New York State Department of Taxation and Finance may require petitioner to file reports for the years involved on a combined basis with its subsidiary, Sears Roebuck Acceptance Corporation ("SRAC"); and, if so, whether (2) in computing the property ratio of the three-factor business allocation formula, SRAC's intangible property should have been included; and (3) in computing the receipts ratio of the three-factor formula, SRAC's interest income should have been included.

Sears is, and was during the years involved, a nationwide retailing company. At all times relevant, its main office and principal place of business was in Chicago, Illinois, and it did business in every state in the United States, and the District of Columbia.

SRAC is a wholly-owned subsidiary of Sears. It was incorporated in 1956 under the laws of the State of Delaware and its only office is, and at all times relevant was, located in Delaware. During the years at issue, SRAC had no office in New York, did no business in New York and was not subject to the New York franchise tax. It has never filed returns in New York and has never been assessed any tax by New York.

SRAC's principal business is, and at all times relevant was, to obtain funds by (a) direct placement of commercial paper notes in the open market, (b) demand borrowings under agreements with bank trust departments, and (c) private placement with bank trust departments of variable interest rate notes collectible after 13 months. SRAC also obtained funds through the sale of medium-term notes on a directly-placed basis with institutional investors. SRAC loans funds to Sears and receives in return Sears promissory notes. The rate charged by SRAC at all relevant times was derived by a formula intended to fix SRAC's ratio of earnings to fixed charges at 1.5 to 1. In the ordinary course, SRAC did not purchase Sears' accounts receivable, except for certain isolated sales on the last day of each fiscal year involved.

SRAC is not involved in Sears' provision of charge accounts and credit to customers, which has always been handled by Sears' credit department. The sale of Sears' accounts receivable, primarily to banks, has always been handled by Sears' treasurer's department, and no sales were made to SRAC other than the ones referred to above.

SRAC was created and maintained as an entity separate from Sears for a number of valid business purposes, as set forth in the affidavit of Robert F. Gurnee, the former president and chief executive officer of SRAC.[1] Because it is separately organized, SRAC is able to borrow at the lowest interest rates available to direct issuers of commercial paper. Sears cannot borrow at those

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[1]The pertinent facts established by Mr. Gurnee's affidavit which was attached as an exhibit to the stipulation are stated herein.

low rates. SRAC's debt-to-capital-funds- employed ratio is much more favorable than Sears'. General mercantile corporations ordinarily invest a portion of their funds in plant and inventory, while the funds of financial corporations are typically invested in self-liquidating, relatively short-term intangible assets. Therefore, general corporations generally face a borrowing limit of $1.00 or less of senior debt to each $1.00 of equity, while financial corporations, whose assets are more readily marketable, are able to borrow $4.00 or $5.00 of senior debt for each $1.00 of equity or subordinated debt. During 1966 through 1975, SRAC's debt-to-capital-funds-employed ratio ranged from 4.99 to 1 to 3.11 to 1. SRAC, because of its financial structure, consistently meets the restrictions placed by many states upon the types of investments that can be made by certain organizations such as banks, insurance companies, pension funds, trust officers, and state entities, and often is able to place its commercial paper with these organizations.

SRAC was created as a finance company separate from Sears for legitimate business purposes. Among other things, the creation of SRAC enabled Sears to raise necessary funds at the lowest possible rates in the open market. In addition, the market would view SRAC as a more creditworthy operation due to its separate capitalization. The reasons for the creation of SRAC as a separate finance company are summarized in the affidavit of H. Russell Fraser. Mr. Fraser's employment included the position of Vice President of Standard and Poor's Corporate Finance Department where he was responsible for all corporate bond and commercial paper ratings, and the position of Vice President and Manager of the Fixed Income Research Department where he was required to keep investors advised as to the credit worthiness of the major issuers of senior securities in the capital markets. Although Mr. Fraser's affidavit was prepared in 1977, he stated that he was fully familiar with the operation of SRAC and Sears, and made his statement based on that knowledge. An excerpt from Mr. Fraser's affidavit follows:

> "The creation of SRAC occurred at a point in time in financial history when the only sizable participants in the commercial paper market were financial companies who sold their paper directly. The commercial paper market competed with instruments of the commercial banking system and Treasury bills. While a few major industrial corporations were participating in the commercial paper market through what was called the dealer market, the extent this market was being used at that time was

> relatively small and inefficient, and in no way was the dealer market capable of financing the quantity of funds SRAC required.
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> "The decision to form SRAC in 1956 was based on sound business judgment and was consistent with what other major money market borrowers were doing, whether they were financing consumer receivables or whether they were financing receivables from large capital goods manufacturers as automobiles, farm machinery equipment and/or receivables related to a variety of other capital goods. Sears chose to establish SRAC because it afforded a means to capture for Sears' shareholders banking profits which otherwise would have been earned by the commercial banking fraternity. This method of using a finance company placed the business of economically obtaining short-term funds in a separate entity specifically designed to perform this function. The separate organization of this activity was and still is required to enable such a large undertaking to be successful."

SRAC is, and was at all times relevant, one of the largest financial companies in the United States. It competes for capital resources directly with commercial banks, with other large financial companies, such as General Motors Acceptance Corporation and Ford Motor Credit, and with Treasury bills and Federal agency short-term notes. In terms of total assets, SRAC is, and at all times relevant was, the fourth or fifth largest non-bank finance company in the United States. During the years involved, SRAC's loans receivable averaged over $6.4 billion.

For the fiscal year ended January 31, 1981, Sears originally filed its New York corporate franchise tax return on a separate basis. At all times relevant, and by this action, Sears protested and continues to protest the correctness of a combination. Nonetheless, Sears filed its franchise tax return on a combined basis with SRAC for the fiscal year ended December 31, 1981, and computed its liability as described below.

SRAC holds large amounts of intangible property. That property alone generates SRAC's income. In computing the New York combined return for the fiscal year ended December 31, 1981, SRAC included its intangible property in the denominator of the reported combined property factor.

SRAC's only receipts were its interest receipts.

On the basis of its combined report, Sears paid $1,328,069.00 in franchise taxes for the year ended December 31, 1981.

Sears then filed an amended return for the taxable year ended January 31, 1981, reporting on a combined basis with SRAC, and including SRAC's intangible property in the denominator of the property factor, which is used in the computation of the business allocation percentage. The business allocation percentage is used to apportion entire net income to New York. With its amended return, Sears paid additional franchise taxes, for a total of $1,003,488.00 in franchise taxes for the year ended January 31, 1981.

The Division contends that (a) Sears should file combined reports with SRAC for the years involved, and (b) SRAC's intangible property should not be included in the combined returns' business allocation percentage factors. The Division recomputed the three-factor formula by removing SRAC's intangible property from the property factors. Notices of deficiency were timely issued in the amounts of $132,234.00 for the year ended January 31, 1981, and $171,699.00 for the year ended December 31, 1981. The notices issued for the periods ended December 31, 1981 and January 31, 1981 included interest of $67,674.00 and $71,425.00 for total assessments of $239,373.00 and $203,659.00, respectively.

During the years involved, more than 99.9% of SRAC's property was intangible property, all of which was located in Delaware. In computing the property ratio, the Division did not include this intangible property owned by SRAC in the denominators of the property factors used to compute Sears' business allocation percentages.

We modify finding of fact "16" of the Administrative Law Judge's determination to read as follows:

> During the period in issue, SRAC receipts were solely from transactions with its parent corporation, Sears. In computing the combined receipts factor of the Sears group combined business allocation percentage pursuant to Tax Law § 210(3)(a) and Franchise Tax Regulation § 4-1.2, such receipts are eliminated as

intercompany receipts (Capital Cities Communications v. State Tax Commn., 65 AD2d 25).[2]

We modify finding of fact "17" of the Administrative Law Judge's determination to read as follows:

> In Sears, Roebuck and Company v. Franchise Tax Board (Cal Sup Ct, December 14, 1983), settled on appeal, the California Superior Court held that, for the period February 1, 1967 through January 31, 1973, the Franchise Tax Board could properly require a combination of the incomes of Sears and SRAC, but the apportionment formula used for purposes of computing Sears' California franchise tax must attribute SRAC's income to its "true income producing sources", and must include SRAC's intangible property and interest income in the combined returns' factor. The Court specifically found that Sears and SRAC "constituted a unitary business" and, therefore, that combination was appropriate.[3]

We modify finding of fact "18" of the Administrative Law Judge's determination to read as follows:

> If Sears prevails and is not required to file combined reports with SRAC for the years involved, Sears would be entitled to reductions in tax due of $429,393.00 for the year ended January 31, 1981 and $854,113.00 for the year ended December 31, 1981. Thus, Sears would not be liable for deficiencies and would be entitled to refunds of $297,159.00 for the year ended January 31, 1981 and $682,414.00 for the year ended December 31, 1981.[4]

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[2]The Administrative Law Judge's finding of fact "16" read as follows:

> "During the years involved, SRAC's only receipts for purposes of computing the business allocation percentage were its interest receipts. In computing the receipts ratios, the Division did not include the SRAC receipts in the denominators of the receipts factors used to compute Sears' business allocation percentages."

We modified this fact as proposed by the Division to indicate the basis for the Division's actions on audit.

[3]We modified the Administrative Law Judge's finding of fact "17" by adding the last sentence, as proposed by the Division, to more fully reflect the Court's decision.

[4]We modified finding of fact "18" of the Administrative Law Judge's determination by eliminating the recalculation charts which we feel are unnecessary.

We modify finding of fact "19" of the Administrative Law Judge's determination to read as follows:

> If Sears is required to file combined reports with SRAC, and SRAC's intangible property and interest income are included in the factors, Sears will be entitled to a reduction in tax due of $114,978.00 for the year ended January 31, 1981, for a total tax of $1,020,744.00, and a reduction in tax due of $169,115.00 for the year ended December 31, 1981, for a total tax of $1,330,653.00. Thus, the proposed deficiencies would be reduced to $17,256.00 for the year ended January 31, 1981 and $2,584.00 for the year ended December 31, 1981.[5]

On January 17, 1985, petitioner timely filed a Petition for Redetermination of Deficiencies and Claims for Refund.

On April 28, 1987, petitioner timely filed a Perfected Petition.

On September 9, 1987, the Division filed its Answer to the Perfected Petition.

Concurrent with the submission of petitioner's post-hearing brief, petitioner submitted proposed findings of fact. After careful review of the record and consideration of the testimony given, the following proposed findings of fact have been accepted and are incorporated below.

SRAC was located in Delaware to take advantage of the State's proximity to the east coast financial markets, the quality of the local labor pool, and the established body of Delaware corporate law.

The rate charged by SRAC was derived by a formula intended to fix SRAC's ratio of earnings to fixed charges at 1.5 to 1. This rate was originally chosen because it was, in SRAC's early days, the rate required by statute to qualify SRAC's commercial paper as permitted investments for New York insurance companies. The 1.5-to-1 ratio later became an industry standard, and by maintaining that rate SRAC was able to compete effectively in the commercial paper market, and attract investments not only from insurance companies but from the many other large companies and institutions that adopted the 1.5-to-1 ratio. During the years in issue, the

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[5]We modified finding of fact "19" of the Administrative Law Judge's determination by eliminating the recalculation charts as unnecessary.

1.5-to-1 ratio generated an average loan rate paid by Sears to SRAC of 15.78%, which was nearly identical to the prime rate during these years.

During the years in issue, SRAC had 45 to 48 employees located in Delaware, who managed and operated its business, entirely independent of the Sears operation in Chicago. SRAC had its own computer system and outside legal counsel. Sears never provided SRAC with clients lists, suppliers, contacts, suggestions for sources of money or loan guarantees. There were no common officers or directors. SRAC's business was dynamic and volatile, and dependent on an intimate knowledge of the paper market. It was not, and could not have been, managed by anyone at Sears, 900 miles away in Chicago.

We modify finding of fact "26" of the Administrative Law Judge's determination to read as follows:

> If SRAC had had excess funds and lent them to another borrower with a credit rating similar to that of Sears, the loan would have had to have been at the same rate as the loans to Sears, in order to generate the same 1.5-to-1 ratio. If Sears had borrowed from another finance company, it would have had to pay the same rate.
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> All of the funds which SRAC earned in commercial market transactions were loaned to its parent Sears. These amounts provided Sears with a majority of its financial requirements, financing over three-quarters of that corporation's outstanding receivables. The extent of SRAC's activities was dictated solely by Sears' daily cash needs. This control which Sears exercised over its subsidiary's activities was grounded in the parent's operational strategy: Sears was assured that it would meet its cash requirements without compromising its own financial positions, and was not dependent upon collecting accounts receivable to meet expenses. By establishing a captive finance subsidiary, Sears enjoyed substantial transactional savings: it was able to obtain significant amounts of money, at rates which were more favorable than Sears (a retail corporation) would receive, and under terms which were not subject to limitations ordinarily imposed by lenders to mercantile corporations.[6]

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[6]We modified finding of fact "26" of the Administrative Law Judge's determination by adding the last paragraph, as proposed by the Division, to more fully reflect the record.

The operations of finance companies like SRAC are similar to the operation of banks, except that finance companies do not accept deposits and are therefore not as heavily regulated. Their activities and borrowing ability is the same as that of banks. If SRAC had not been formed, Sears would have borrowed from a bank instead, and the income earned by SRAC would have been earned by a bank. That income could never have been earned by Sears if it and SRAC were one operation.

Upon audit, the Division required Sears to file a combined report covering SRAC. The Division decided that Sears and SRAC were operating a unitary business because SRAC borrowed funds and relent them to Sears. It made no analysis of whether Sears and SRAC were "unitary" under the factors discussed in a series of Supreme Court cases, ASARCO, Inc. v. Idaho State Tax Commn. (458 US 307 [1982]); F. W. Woolworth Co. v. Taxation & Revenue Dept. of New Mexico (458 US 354 [1982]); Container Corp. of America v. Franchise Tax Board (463 US 159 [1983]). It made no finding of functional integration, centralized management or economies of scale.

The Division also determined that the relationship between Sears and SRAC was not arm's length, because SRAC was "guaranteed a profit" by the use of the 1.5-to-1 ratio in setting the loan rate to Sears. The Division did not know or investigate whether the 1.5-to-1 ratio was an arm's-length rate, standard in the commercial paper industry.

In computing the combined report it deemed necessary, the Division combined Sears' income with SRAC income and applied the business allocation percentage, but gave no factor representation to SRAC in that percentage. Instead, it excluded SRAC's receipts from the receipts factor and SRAC's intangible property from the property factor. As a result, the combination of SRAC and Sears' income is apportioned to New York almost entirely based upon Sears' factors. If SRAC were to move its entire operation to New York, the combined tax would hardly change under the method used by the Division.

The New York State Audit

In February 1983, a corporation tax field audit of Sears for the fiscal periods in issue was commenced by an auditor of the Division's Chicago District Office. The Division offered the testimony of the team leader,[7] Steven Carnevale, who assumed responsibility for the case after the auditor originally assigned to the matter left State service. Mr. Carnevale testified that he participated in that field audit as a team leader, reviewed documents that were submitted and assisted with the preparation of schedules. He testified that the audit group reviewed the New York State tax returns as filed, the Federal tax returns for the same periods, and supporting documentation for those returns. The audit was performed at petitioner's headquarters in Chicago.

Mr. Carnevale testified that, based on his participation in the field audit, he learned that the business of Sears was as a retail merchandiser of a broad line of products sold domestically through retail outlets and catalog stores. He further acknowledged that one of the subsidiary corporations of Sears was SRAC, a 100% wholly-owned subsidiary corporation. His testimony included information pertaining to SRAC as a finance company that borrowed funds from various sources primarily through the issuance of commercial paper and subsequently loaned such funds solely to Sears via the issuance of promissory notes.

As a result of a review of the books and records, there was a conclusion drawn that a combined New York State Franchise Tax Report should be mandated which included Sears and SRAC. The basis for such determination, Mr. Carnevale testified, was the applicable law and regulations pertaining to combined reporting, which included the following four items: an ownership test, a corporation test, a unitary business test, and an intercompany activity test. When questioned about the unitary business requirement, Mr. Carnevale indicated that such a test

[7]Since the testimony of the team leader was the only testimony offered by a person involved with the audit from the Division, any references hereinafter to "the auditor" refer to the testimony of the team leader.

could be met in several ways, including sales to the same customers, one corporation financing the sale of the other corporation's products, and one corporation selling substantially to the other corporation. He stated that as a result of those factual indices a combined report would be necessary since it indicated the nature of a unitary business.

The auditor's testimony revealed that SRAC was not a taxpayer for New York purposes and, when further questioned about his conclusion concerning the unitary business requirement, Mr. Carnevale testified that it was based on the fact that SRAC borrowed funds and relent those funds solely to Sears. Having concluded it was proper to require mandatory combination of petitioner and SRAC, the auditor then proceeded to testify as to the mathematical mechanics of the combination. He outlined the mechanics as including a computation of the income of each individual company on a separate basis, i.e., the computation of entire net income, the addition of such entire net income, applying any appropriate intercompany eliminations, to result in a combined income. The combined income is then apportioned by a three-factor formula comprised of property, receipts and wages, both inside and outside New York State. This formula is referred to as the business allocation percentage.

The auditor's testimony revealed that there was no dispute that SRAC was a separate entity with its own substantial earnings in the State of Delaware. The auditor was questioned with regard to whether there were any findings of other than arm's-length transactions and his response was that there were several items identified that could be construed as failing to meet an arm's-length standard. The first item he noted was that SRAC was guaranteed a profit by the use of the 1.5-to-1 factor charged to petitioner for the funds loaned to the parent corporation. Although reference was made to the fact that such a ratio was custom in the industry, the auditor expressed a lack of knowledge to draw such a conclusion. He was aware, however, that SRAC as a separate entity had the ability to borrow more funds and at a lower rate than could petitioner. The auditor, however, was unaware whether the borrowing could be accomplished without the guarantee of petitioner.

When the auditor was questioned further about the basis for finding a unitary relationship between the corporations, having previously cited the fact that SRAC borrows funds and relends them solely to Sears, he also indicated that the conclusion that the corporations have a unitary relationship was based on an examination of the internal relationship between the corporations and a determination of whether SRAC could exist on its own. In the opinion of the audit team, it could not. Mr. Carnevale's testimony made clear that no analysis was made of whether Sears and SRAC were unitary under factors discussed in various Supreme Court cases. The Division did not attempt to determine whether there was centralized management, functional integration or economies of scale between such corporations. The auditor testified that there was integration between the corporations in the sense that the lending was substantial and SRAC loaned funds solely to Sears for the operation of a portion of its business. However, upon clarification of the term "functional integration", as the Supreme Court has applied it, the auditor testified there was no functional integration between SRAC and Sears.

We modify finding of fact "39" of the Administrative Law Judge's determination to read as follows:

> Petitioner presented the testimony of Robert Gurnee who held numerous key positions with SRAC from 1958 through the end of 1980. Between 1972 and 1980 Mr. Gurnee held the position of president and chief executive officer of SRAC, essentially running SRAC at its Delaware location. In January 1981, he was appointed vice-president and corporate treasurer of petitioner and moved to Chicago to assume his new position. Mr. Gurnee described the full function of SRAC as having consisted of borrowing funds in the open market through a variety of means. He stated that in the commercial paper market, borrowing money from demand master note agreements with bank trust departments, master note borrowings on a 13-month basis with bank trust departments, and the occasional sale of medium term notes was a summarization of the practice of SRAC's business. Having obtained funds in the open market at competitive rates, the funds were then loaned to Sears. Mr. Gurnee described SRAC as having been formed to fulfill a need in 1956. He joined the company in 1958 and at that time Sears was financing its receivables by selling them to banks, and in its normal course of operations would have approximately $900,000,000.00 worth of receivables out to banks. Since Sears was in a position of reaching legal lending limits and

> showed concern about its future and growth in terms of demands for operating capital, the finance company evolved. He testified that the commercial paper market had grown over the years, and presently is the largest single market for providing capital to corporations. The concept of a finance company was so attractive because of the self-liquidating nature of the receivables. SRAC and like companies could borrow up to eight-to-one, i.e., for each dollar of its capital base it could borrow up to eight dollars. However, with a non-financial company, since such a significant portion of its capital is invested in real property and inventory, the ability to borrow is significantly more restricted. In fact, a non-financial company would have been allowed to borrow only approximately 60% of its equity base. In addition, Mr. Gurnee testified that the rates obtainable by such corporations differed. This self-liquidating nature of receivables of the finance company gave it an ability to get into the direct issue commercial paper market and tap such market at a much better rate than a retailer or non-financial company.
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> Historically, a New York State law existed whereby a finance company was required to maintain a level of 1½ times fixed charges. Simply, if SRAC was to meet such requirement and was paying 4% interest, it had to collect income from Sears at a rate of at least 6%. Over time, the 1½ times fixed charges became an industry standard. Mr. Gurnee testified that as compared to funds Sears could have obtained in the open market, petitioner was paying a competitive but comparable rate. For example, in 1980 the average prime rate which Sears would have had to pay was approximately 15.80%. The average return to SRAC for money loaned to Sears during that same period was 15.78%. The evidence offered in this matter establishes that this rate is incorporated in agreements between SRAC and its commercial market lenders (Tr., pp. 121, 138).[8]

Mr. Gurnee's testimony also revealed that SRAC was placed in Delaware as a strategic location where it was considered to be in the center of a very stable labor market, as well as in a state with a well developed body of corporate law. During the years in issue, SRAC employed between 45 and 48 persons and had its own computer operations. There were no common officers between Sears and SRAC.

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[8]We modified finding of fact "39" of the Administrative Law Judge's determination by adding the last sentence to the second paragraph to more clearly state the record.

Mr. Gurnee was asked to explain the interaction between Sears and SRAC vis-a-vis the exchange of funds. He indicated that Sears has a vast cash management system, with 1700 to 1800 units reporting in each day. Sears determines a daily net position (funds received less funds disbursed) and maintains contact with SRAC to report the position for the purpose of meeting maturities and borrowing additional funds for operating capital. The notes exchanged between Sears and SRAC are maintained in increments of billions of dollars and the balance fluctuates each day. But essentially the contact between the companies is solely between Sears' treasurer's department and the cash manager of SRAC. Mr. Gurnee's testimony also supported the explanation provided by petitioner regarding the beneficial position of a financial company due to its self-liquidating assets with respect to its borrowing power and the preferential rates it could obtain.

Mr. Gurnee's testimony was followed by that of Ashwinpaul Sondhi, an associate professor of accounting at New York University whose credentials include a PhD in accounting. His teaching and research are in the areas of accounting and financial analysis. He has spent a great deal of time studying finance companies, both captive and independent, and has published numerous articles about the attributes of finance companies, why they exist, the extent of their debt capacity, and the relationship between the parent and the finance company. Professor Sondhi reviewed the financial statements of Sears and SRAC, the stipulation of facts as submitted in this matter and the financial statements of approximately 20 companies that are either independent or captive finance companies, along with the contractual agreements with their lenders.

Professor Sondhi's testimony reconfirmed that SRAC and similar finance companies are established for the sound business reason that capital markets do not allow non-financial companies to borrow generally more than up to 60% of their equity due to the risk of their operations. Where a subsidiary corporation is established as a finance company it is designed to ensure that its cash flows and net worth can be made both liquid and safe to the extent that

financial markets allow for borrowing of up to eight times equity. Professor Sondhi testified to these facts on the basis of his review of actual borrowings on behalf of the previously mentioned 20 finance companies during the years in issue. He compared the activities of a finance subsidiary such as SRAC to that of a bank with the exception of two critical differences: (1) finance companies do not accept deposits and (2) they are not regulated to the same extent by the Federal Reserve or by state regulating agencies. He noted that one of the most important characteristics of the finance subsidiaries that allow for a favorable borrowing situation is the fact that its assets are self-liquidating.

Professor Sondhi also discussed the provision of the Insurance Law which requires insurance companies to invest only in financial companies earning at least 1½ times their fixed costs. He stated that the ratio is not unique to SRAC and is used by both captive and independent finance companies. He concluded that had SRAC lent funds to an unrelated corporation having a credit rating equivalent to Sears', the rate would have had to meet the same ratio. Likewise, if Sears were borrowing from another finance company, the same or similar amounts would have been charged. For purposes of the discussion, he explained that a captive finance company is one that does at least 70% of its business with the parent company, such as in this case. He compared a captive finance company to an independent one which does not conduct a majority of its transactions with a parent company. The 20 companies reviewed and the analysis performed involved a variety of captive and independent finance companies.

Professor Sondhi's testimony and a prepared written report submitted into evidence discussed the historical New York Insurance Law requirement referred to previously. The law designated debt securities of subsidiary financial companies as eligible investments when the subsidiary financial company maintains a prescribed ratio of earnings to fixed operating expenses. Professor Sondhi reports that because of this ratio financial markets view the risk involved in doing business with financial subsidiaries as significantly lower, thus allowing them greater access

to capital and lower interest and financing expenses. These and other resulting financing benefits cannot be duplicated by non-financial companies which are denied access to financial markets because they lack such characteristics. Professor Sondhi believes that combination of SRAC and petitioner ignores the fact that, from an economic perspective, if SRAC had not been created, and its business activities were assumed by its parent, the income SRAC produces would not exist. Sears would not have been able to produce the income to the extent produced by SRAC due to the factors unique to financial corporations and treating such income as if it had been earned by Sears overstates the income of petitioner and distorts the portion of combined income actually attributable to Sears' activities.

Petitioner offered the testimony of Richard Genetelli, a partner of the certified public accounting firm of Coopers & Lybrand. He has maintained a position with the State and Local Tax Division of the firm for more than 10 years and he was qualified as an expert in accounting and economics. Mr. Genetelli reviewed the tax returns filed by petitioner, as well as the audit report and the stipulation of facts offered into evidence. He concluded that SRAC and Sears should not be combined because the transactions between the corporations are on an arm's-length basis. He does not believe distortion results by the separate company filing of these corporations and stated that a combined report is not necessary to correct any distortion. Furthermore, Mr. Genetelli established in his written report also submitted into evidence that there is an inherent distortion in combining mercantile and financial companies. He explains by saying that a finance company generates income from intangible assets, whereas a mercantile company generates income from the sale of tangible personal property. As a result, the mercantile company uses a normal apportionment formula consisting of property, payroll and receipts in apportioning income to New York State. However, application of the normal three-factor formula to a financial company does not consider certain factors which are relevant to the company in generating income. Thus, such a combination would result in distortion of income.

OPINION

Article 9-A of the Tax Law imposes a tax on foreign corporations doing business in New York State (Tax Law § 209[1]). In order to properly reflect that tax liability, Tax Law § 211(4) gives the Division the discretion to require or permit corporations subject to New York State tax to file combined reports with certain other corporations. The statute requires that the parent own or control substantially all of the stock of the subsidiary. The statute further limits the Division's discretion by providing that "no combined report covering any corporation not a taxpayer shall be required unless the [Division] deems such a report necessary, because of inter-company transactions . . . in order to properly reflect the tax liability" (Tax Law § 211[4]).

The Division's regulations provide that the Division may require or allow the filing of a combined report where three conditions are met: (1) a stock ownership test (20 NYCRR 6-2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3). The distortion of income test provides, in part, that the Division:

> "may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations" (20 NYCRR 6-2.3[a]).

This presumption is one that can be rebutted by the taxpayer by showing that the transactions between the corporations are at arm's length (see, Matter of USV Pharm. Corp., Tax Appeals Tribunal, July 16, 1992 [use of Federal 482 adjustments appropriate to show arm's-length pricing] and Matter of Standard Mfg. Co., Tax Appeals Tribunal, February 6, 1992; see also, Matter of Campbell Sales Co., Tax Appeals Tribunal, December 2, 1993 [the Tribunal will apply section 482 principles in the absence of Federal section 482 adjustments]). The unitary business test and the distortion of income test are interrelated factors under the Division's regulations in that both

focus on the same activities (cf., 20 NYCRR 6-2.2[b] concerning the unitary test and 20 NYCRR 6-2.3[c] concerning the distortion test).[9]

The Administrative Law Judge determined that Sears and SRAC were not engaged in a unitary business and, assuming arguendo that they were unitary, that there was no distortion of income because the intercorporate transactions were at arms length. The Division, on exception, disagrees with both of these conclusions. Petitioner agrees with the determination of the Administrative Law Judge. We will examine each issue separately.

We begin with the issue of whether Sears and SRAC were engaged in a unitary business.

The Administrative Law Judge determined that the Division made no analysis of whether Sears and SRAC were unitary within the meaning of the various Supreme Court decisions.[10]

The Administrative Law Judge found that:

> "[t]he record developed by petitioner . . . reflects the fact that Sears and SRAC conducted their own fully self-contained businesses. The corporations had their own accounting departments, financial staff and outside counsel, no central personnel training program, no rotation or exchange of personnel and maintained separate

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[9]For example, both sections of the regulations use "financing of sales of other corporations in the group" and "selling goods acquired from other corporations in the group" as examples of "activities" (20 NYCRR 6-2.2[b]) and "transactions" (20 NYCRR 6-2.3[c]) to be examined in making the determination of unitary and intercorporate transactions, respectively.

[10]The Administrative Law Judge stated that:

> "[t]here was no inquiry as to whether the businesses were operated as one and whether they were under the direction of a common group of people. There was no finding of functional integration, centralization of management or economies of scale. The Division relied upon the fact that SRAC had a guaranteed market given its relationship with Sears. This was an insufficient analysis of whether a unitary business relationship existed between the two. The loans themselves do not establish the functional integration required by due process considerations. As the facts were presented herein, Sears and SRAC each operate a discrete business enterprise with a 'notable absence of any "umbrella of centralized management and controlled interaction"' (Exxon Corp. v. Wisconsin Dept. of Revenue [447 US 207, 224, 65 L Ed 2d 66])" (Determination, conclusion of law "I").

> responsibility for the development and training of their own management. They did not utilize a central purchasing function or facilitate sales through a uniform credit system or uniform packaging. The 'managerial links' as described by the testimony were necessary and commonplace for the type of financial transactions that took place. There was no more of an interrelation between Sears and SRAC than Sears would have had with a non-related lender" (Determination, conclusion of law "I").

The Administrative Law Judge concluded that Sears and SRAC were not engaged in a unitary business.

On exception, the Division asserts that Sears and SRAC are engaged in the unitary business of the retail sale of merchandise in that there is the requisite flow of value between the two corporations, functional integration and centralized management. The Division asserts that the requisite flow of value between the two is evidenced by the corporations' substantial interdependence.

> "Clearly SRAC is substantially involved in financing the sales of Sears . . . through loans made to Sears from the proceeds of its sale of commercial paper . . . [which] . . . funds are used to maintain and expand Sears' working capital requirements. As a direct result of the SRAC financing, Sears is neither dependent upon collecting its accounts receivable to meet day-to-day operating expenses, nor limited to amounts of credit banks are permitted to extend. Instead, Sears, through SRAC's activity is assured sufficient capital to carry on its business, as well as to maintain its position as a retail merchandiser" (Division's brief, p. 26).

The Division asserts that functional integration is evidenced by the fact that:

> "[t]he activities of SRAC are wholly governed by the daily capital needs of its parent: SRAC only enters into commercial market transactions when Sears requires financing. (Tr. 93-4.) SRAC enjoys an economic viability as a direct result of Sears' initial capitalization and Sears' continued income contributions. (Tr. 106.)" (Division's brief, pp. 27-28).

The Division asserts that centralized management is evidenced by the fact that the "scope and extent of all of SRAC's activities are dictated by the parent" (Sears') operational financial needs (Division's brief, p. 29).

On exception, petitioner argues, as it did at hearing and for the reasons stated in the Administrative Law Judge's determination, that SRAC and Sears were discrete business operations and were not engaged in a unitary business.

We reverse the determination of the Administrative Law Judge on this issue.

We start with the basic principle that in order for a state to tax the multi-state income of a nondomiciliary corporation:

> "there must be 'a "minimal connection" between the interstate activities and the taxing State,' [cites omitted] and there must be a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business [cite omitted] . . . . [a] State need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary [cite omitted]. A State may not tax a nondomiciliary corporation's income, however, if it is 'derive[d] from "unrelated business activity" which constitutes a "discrete business enterprise"'" (Allied Signal, Inc. v. Director, Div. of Taxation, ___ US ___, 112 S Ct 2251, 2254-2255).

In Matter of British Land (Maryland) (Tax Appeals Tribunal, September 3, 1992, affd ___ AD2d ___ [Mar. 24, 1994]), we summarized the current status of the unitary business principle as follows:

> "The constitutional prerequisite to an acceptable finding of unitary business is a flow of value (Container Corp. of Am. v. Franchise Tax Bd., 463 US 159, 178). The constitutional test focuses on functional integration, centralization of management and economies of scale (Allied-Signal, Inc. v. Director, Div. of Taxation, ___ US ___, 112 S Ct 2251, 2252, 2261)" In Allied-Signal, the Supreme Court recently clarified the meaning and application of these factors by stating that these essentials could respectively be shown by: transactions not undertaken at arm's length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business (Allied-Signal, Inc. v. Director, Div. of Taxation, supra, 112 S Ct 2251, 2264)" (Matter of British Land [Maryland], supra).

The burden is on the taxpayer to show that imposition of the State tax results in extraterritorial values being taxed because the income is derived from a discrete business enterprise, not a unitary business (Exxon Corp. v. Wisconsin Dept. of Revenue, supra).

Here, despite the separate corporate structures Sears has not shown that it and SRAC were engaged in discrete business enterprises. Rather, the facts show an overwhelming interdependence between the two -- a clear underlying unity of the business enterprise. Specifically, SRAC derives all of its income from its transactions with Sears and all of Sears' access to the credit markets is through SRAC. The extent of SRAC's activities was dictated solely by Sears' daily cash needs. Sears' treasury department and SRAC's cash manager interacted on a daily basis.[11] This control which Sears exercised over its subsidiary's activities was grounded in Sears', the parent, operational strategy. Sears was assured that it would meet its cash requirements without compromising its own financial positions. By establishing a captive finance subsidiary, Sears enjoyed substantial transactional savings since it was able to obtain significant amounts of money, at rates which were more favorable than Sears (a retail corporation) would receive, and under terms which were not subject to limitations ordinarily imposed by lenders to mercantile corporations. We need not struggle to categorize these facts under the specific indicia enunciated by the Court nor determine whether any one of them is sufficient alone to prove the existence of a unitary business (see, Container Corp. of Am. v. Franchise Tax Bd., supra, at 180). Suffice it to say that, taken in combination, they show mutual interdependence with clear centralization of basic business decisions and economies of scale.

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[11]Mr. Gurnee was asked to explain the interaction between Sears and SRAC vis-a-vis the exchange of funds. He indicated that Sears has a vast cash management system, with 1700 to 1800 units reporting in each day. Sears determines a daily net position (funds received less funds disbursed) and maintains contact with SRAC to report the position for the purpose of meeting maturities and borrowing additional funds for operating capital. The notes exchanged between Sears and SRAC are maintained in increments of billions of dollars and the balance fluctuates each day.

We conclude that Sears and SRAC were engaged in a unitary business.[12]

Having concluded that Sears and SRAC were unitary, we deal now with the final aspect of New York's regulatory provisions, the distortion issue, i.e., whether the transactions between Sears and SRAC were at arm's length.

The Administrative Law Judge concluded that Sears proved that the intercorporate transactions between the two were on an arm's-length basis. The Administrative Law Judge found that petitioner:

> "presented the credible testimony of Robert Gurnee, a key management figure in the SRAC operation from 1958 through 1980. Intimately involved with the early years of SRAC, Mr. Gurnee testified to its historic evolution and the role played by companies such as this one. He spoke about the return rate on the loans to Sears from SRAC and characterized both the companies' manner of operations and structure of the loans as arm's length" (Determination, conclusion of law "L").

The Administrative Law Judge also found persuasive:

> "Professor Sondhi['s] . . . experience and current review of approximately 20 independent and captive finance companies and the contractual arrangements that those companies maintained with their lenders. He compared such information to SRAC policies. He confirmed other testimony that set forth the business reasons a finance company is utilized, especially where the borrowing power of a merchandising corporation remains so limited. He concluded that had SRAC lent the same funds to an unrelated corporation pursuant to its lending agreement, a standard document for such transactions, the corporation would have had to meet a credit rating

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[12]The California Court reached the same result:

> "[t]here was unity of ownership and operation of Sears and SRAC. Sears owned all of the outstanding common stock of SRAC and SRAC made 100% of its loans to Sears. Sears let SRAC know its daily financing needs and SRAC would borrow money accordingly. The Court finds that the evidence shows that Sears and SRAC constituted a unitary business" (Sears, Roebuck & Co. v. Franchise Tax Bd. of the State of California, Super Ct, Los Angeles County, Dec. 14, 1983, No. C 248013).

Under similar circumstances, we reached the same result in Matter of Autotote, Ltd. (Tax Appeals Tribunal, April 12, 1990).

> similar to Sears and the rate charged would have had to adhere to the ratio requirements. If Sears had borrowed from an unrelated source, it would have been facing the same charges. Testimony regarding the prime rate during the years in question established such fact" (Determination, conclusion of law "L").

Finally, the Administrative Law Judge found the testimony of petitioner's third witness, Mr. Richard Genetelli, also persuasive in that it confirmed that separate filing would properly reflect the tax liability "because the only transactions between the two corporations are clearly arm's-length" (Determination, conclusion of law "L).

In the face of the evidence provided by petitioner, the Administrative Law Judge found that the Division:

> "failed to rebut petitioner's position by presenting any evidence or testimony that could result in a conclusion that the transactions were not arm's-length or that separate filing would not properly reflect the tax liability of Sears.
>
> "Petitioner has achieved a critical goal necessary to overcome the presumption of distortion by its creation of a record of reports and testimony which, taken in its entirety under these facts and circumstances, meets the burden placed upon it to show that a separate filing would properly reflect petitioner's tax liability and that combination of Sears and SRAC is not necessary to achieve proper reflection" (Determination, conclusion of law "N").

On exception, the Division asserts that Sears has not rebutted the presumption of distortion from filing on a separate basis which arises when the three criteria of the Division's regulations are met, i.e., stock ownership, unitary business and substantial intercorporate transactions (20 NYCRR 6-2.1).

> "First, it should be noted that this matter does not present facts of IRS intercorporate pricing adjustments. Consequently, it is not possible to look to parallel IRS review to determine if (1) intercorporate pricing was or was not at arm's length and, if not at arm's length, (2) whether adjustments to intercorporate pricing had been made which would overcome the factual presumption of distortion" (Division's brief, p. 42).

Moreover, asserts the Division, the arm's-length standard may be relevant but "may not be substituted for the articulated standard of proper reflection of income" (Division's brief, p. 43).

> "If the principles of Section 482 are to apply, however, at the very least [Sears] must establish that a rigorous analysis comparable to that required by the Code Regulations has been made [cite omitted]. Federal regulations require more than a mere statement of opinion as to the characterization of the transactions being examined" (Division's brief, pp. 45-46).

The Division asserts that:

> "[t]here is no proof . . . that Sears' transactions with SRAC were comparable to Sears' transactions with unrelated lenders. . . .
>
> "There are no facts presented in this matter which establish that SRAC is remunerated by its parent . . . in an amount which is equal to that which an uncontrolled finance corporation would receive dealing at arm's length with an uncontrolled retail merchandising corporation. Application of an 'arm's length' standard, therefore, is inappropriate" (Division's brief, pp. 46-47).

The Division rejects the testimony and report of Mr. Sondhi because he "did not submit specific information which supports his generalizations" (Division's brief, p. 48). Specifically, the Division asserts that Sears:

> "has not established that the Sears-SRAC transactions were in fact at arms' length. Sears' witnesses did testify at length concerning the evolution and application of the fixed 1.5 expense factor (cite omitted). It may very well be that this expense factor has been adopted by the captive financial 'industry' (cite omitted).
>
> "A requirement imposed on a captive finance corporation by unrelated third-parties which are purchasing the captive's commercial paper, however, does not amount to evidence that the captive's transactions with its parent are at arm's length. If compliance with the fixed charge is proved, only the terms of the captive's agreement with its lenders has been established.
>
> "Proof of the expense factor does not establish that the terms of the promissory notes transactions between Sears and SRAC were in fact comparable to promissory note transactions between a financial corporation and an unrelated mercantile corporation. The 1.5 factor is simply a requirement placed upon SRAC by its <u>lenders</u>: that is, it does not necessarily represent arm's length pricing between a retail corporation and its captive finance subsidiary. In fact, SRAC could charge Sears according to a variety of methods, as long as the income paid to SRAC was equivalent to one-and-one-half times SRAC's costs of its commercial paper transactions.
>
> "Nor are the transactions between Sears and SRAC necessarily accomplished at 'market' rates. Although there may

> have been a point during the period in issue where the interest expense charged Sears was approximately equal to the prime interest rate . . . it is clear from the record that Sears did not obtain substantial bank or other financing on its own account during the period in issue.
>
> "As a direct result of the unique relationship between Sears and SRAC, there is no evidence that the terms of Sears' promissory notes with SRAC are equal to the terms of any hypothetical Sears' borrowings with unrelated parties" (Division's brief, pp. 50-52).

On exception, petitioner argues, for the same reasons stated in the determination of the Administrative Law Judge, that the intercorporate transactions were arm's length.

We affirm the determination of the Administrative Law Judge on this issue.

In determining whether the transactions at issue were arm's length, we are guided in our analysis by the principles underlying section 482 of the Internal Revenue Code (Matter of Campbell Sales Co., supra).

There is no doubt that "[t]he rate charged by SRAC [to Sears] at all times was derived by a formula intended to fix SRAC's ratio of earnings to fixed charges at 1.5 to 1" (Stipulation, Exhibit "A," ¶ 4). We need to determine whether this is the rate which SRAC would have charged to an unrelated corporation. The Administrative Law Judge found the analysis and the testimony of Mr. Sondhi, as well as Mr. Gurnee and Mr. Genetelli, persuasive on this point. So do we.

Mr. Sondhi reviewed: the financial statements of Sears and SRAC; the stipulation entered into by the parties; the financial statements of the 20 largest companies that are either independent or captive finance companies; and the contractual agreements between these companies and their lenders.[13] He prepared a report concerning SRAC and Sears (Petitioner's exhibit "2") in which he concluded, based on his analysis, that the transactions between SRAC and Sears were at arm's length because the market demands that finance companies like SRAC must earn at least one-and-one-half times their fixed costs, i.e., the interest SRAC pays to the purchasers of its commercial

[13]The companies are listed in the American Banker (Exhibit "2" of the stipulation, pp. 113, 127) and include SRAC as the fifth largest company. The records reviewed are available to the public (pp. 113, 127, 128).

paper. This market demand is represented in the contractual agreements between the finance companies, here SRAC, and its lenders. The one-and-one-half is the rate charged by SRAC to Sears and it is the rate SRAC would have to charge other borrowers, and Sears would have to pay the same rate if it borrowed from another captive or independent finance company (see, Sondhi report, p. 6, Petitioner's exhibit "2").

Further, Mr. Sondhi noted that the agreements between SRAC and its lenders would require that the transactions between SRAC and Sears be at "arm's length," a term which he defines as "strictly comparable to what you can get in the marketplace."

Mr. Sondhi's conclusion that the transactions were arm's length was supported by petitioner's other expert witnesses, Mr. Gurnee and Mr. Genetelli. The Division, on the other hand, offers nothing which, in any way, controverts the evidence offered by petitioner.

In view of our conclusion that the transactions were arm's length, petitioner has rebutted the presumption of distortion resulting from the substantial intercorporate transactions. The Division offers no other evidence to show that filing on a separate basis distorts the income of Sears, i.e., does not result in a proper reflection of income. Accordingly, we conclude that the Division cannot require that Sears and SRAC file a combined report. This conclusion also makes it unnecessary for us to deal with petitioner's exception, i.e., if a combined report is required, the apportionment formula should be adjusted to include: (a) SRAC's intangible property in the property factor and (b) SRAC's receipts in the receipt factor.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted to the extent that we find that petitioner, Sears, Roebuck and Co., and SRAC were engaged in a unitary business, but in all other respects is denied;

2. The exception of Sears, Roebuck and Co. is denied;

3. The determination of the Administrative Law Judge is affirmed except as indicated in paragraph "1" above;

4. The petition and refund claims of Sears, Roebuck and Co. are granted; and

5. The notices of deficiency dated October 22, 1984 are cancelled.

DATED: Troy, New York
April 28, 1994

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner