STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
|---|---|---|
| of | : | |
| **THE NEW YORK TIMES COMPANY** | : | DECISION<br>DTA No. 809776 |
| for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1981, 1982 and 1983. | : | |

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on July 21, 1994 with respect to the petition of The New York Times Company, 229 West 43rd Street, New York, New York 10036. Petitioner appeared by Morrison & Foerster (Arthur R. Rosen, Esq., and James M. Bergin, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (John O. Michaelson, Esq., of counsel).

The Division of Taxation filed a brief on exception. Petitioner filed a brief in opposition. The Division of Taxation filed a reply brief. Petitioner filed a surreply brief. Oral argument was heard on February 15, 1995, which date began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioners Koenig and DeWitt concur.

## *ISSUE*

Whether the Division of Taxation may properly require petitioner, The New York Times Company, and its subsidiary, The New York Times Sales, Inc., to file combined franchise tax reports for the years 1981 through 1983.

***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge except for findings of fact "18," "20" and "27" which have been modified and for findings of fact "28" through "44" which have been omitted.[1] The modified findings of fact and findings of fact "1" through "27" are set forth below.

1. The Division of Taxation ("Division") issued five notices of deficiency dated May 8, 1989 against petitioner, The New York Times Company, asserting the following corporation franchise tax deficiencies:

| Year | Tax | Interest | Total |
|---|---|---|---|
| 1981 | $ 305,337.00 | $ 352,417.00 | $ 657,754.00 |
| 1982 | 435,045.00 | 373,484.00 | 808,529.00 |
| 1982 | 78,828.00[2] | 67,765.00 | 146,593.00 |
| 1983 | 463,664.00 | 302,074.00 | 765,738.00 |
| 1983 | 74,137.00 | 48,300.00 | 122,437.00 |
| | $1,357,011.00 | $1,144,040.00 | $2,501,051.00 |

The Division also issued five statements of audit adjustment dated May 8, 1989 each simply explaining that the asserted deficiencies were "based on recent field audit."

2. A Conciliation Order dated April 19, 1991 reduced the tax deficiency of $1,357,011.00 asserted due for the three years to $968,666.00 because petitioner had provided

[1]We have omitted findings of fact "28" through "44" because they relate to Northern SC Paper Corp. which is not in issue in this exception.

[2] This amount as well as the smaller amount asserted due for 1983 of $74,137.00 represent additional metropolitan business tax surcharges under Tax Law § 209-B.

additional information to show that it had overstated its receipts factor. An auditor's schedule dated March 1, 1991 showed the following summary of the revision in tax asserted due:

| Year | Tax | Additional Tax or Refund | Interest | Total |
|---|---|---|---|---|
| 1981 | 9-A | $(83,008.00) | $ (133,324.00) | $ (216,332.00) |
| 1982 | 9-A | 435,045.00 | 558,646.00 | 993,691.00 |
| 1983 | 9-A | 463,664.00 | 477,436.00 | 941,100.00 |
| 1982 | Surcharge | 78,828.00 | 101,224.00 | 180,052.00 |
| 1983 | Surcharge | 74,137.00 | 76,339.00 | 150,476.00 |
| Total | | $968,666.00 | $1,080,321.00 | $2,048,987.00 |

A second schedule also dated March 1, 1991 showed the following recomputation of tax due:

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Tax on allocated net income | $1,288,531.00 | $1,792,771.00 | $4,355,160.00 |
| Tax on subsidiary capital @ .009 | 17,753.00 | 26,777.00 | 7,152.00 |
| Minimum tax on combined affiliate | 250.00 | 250.00 | 250.00 |
| Total tax before credits | $1,306,534.00 | $1,819,798.00 | $ 4,362,562.00 |
| Less: Investment tax credit | 611,263.00 | 499,466.00 | 1,451,004.00 |
| Franchise tax per audit | $ 695,271.00 | $1,320,332.00 | $2,911,558.00 |
| Tax previously paid | 778,279.00 | 885,287.00 | 2,447,894.00 |
| Additional tax (refund) due | $ (83,008.00) | $ 435,045.00 | $ 463,664.00 |

Metropolitan business tax surcharges for 1982 and 1983 were recalculated as follows:

| | 1982 | 1983 |
|---|---|---|
| Franchise tax per audit | $1,320,082.00 | $2,911,306.00 |
| Metropolitan commuter transportation district (MCTD) allocation % as reported | 97.6261% | 94.1280% |
| Allocated tax | $1,288,745.00 | $2,740,356.00 |
| Surcharge rate | 18% | 17% |
| Surcharge per audit | $ 231,974.00 | $ 465,861.00 |
| Surcharge reported | 153,146.00 | 391,724.00 |
| Additional surcharge | $ 78,828.00 | $ 74,137.00 |

The total of the additional tax (refund) of ($83,008.00) for 1981, $435,045.00 for 1982, $463,664.00 for 1983, and the surcharges of $78,828.00 for 1982 and $74,137.00 for 1983 is $968,666.00, the revised amount asserted as due.

3. As a result of a field audit by the Metropolitan District Office, the Division required petitioner to file combined tax reports with its subsidiary, The New York Times Sales Corp., resulting in the additional tax asserted as due as noted above.

4. The New York Times Company's Annual Report for 1983 (Pet. Ex. "129") includes the following concise description of petitioner in a section labeled "What We Are":

"The New York Times Company takes its name from the distinguished newspaper, founded in 1851, that has become a standard for journalistic excellence.

"In addition to The New York Times, this diversified, publicly-owned communications company publishes 29 smaller-city dailies and weeklies. Its other businesses include three leading magazines, three television stations, two radio stations and a cable TV system. The Company also publishes general books, and syndicates news and features worldwide.

"The Company owns substantial equity interests in three newsprint mills and a supercalendared-paper mill, and a one-third interest in the International Herald Tribune."

5. A section of the 1983 Annual Report entitled "Segment Information" notes that petitioner has classified its business into the following four segments and equity interests:

"Newspapers: The New York Times, a newspaper of general circulation with readership in New York City, its suburbs and throughout the U.S., 29 smaller-city newspapers principally in the southeast, a news service and a features syndicate.

"Magazines: Family Circle, Golf Digest, Golf World, Tennis and Times Books.

"Broadcasting/Cable TV: WREG-TV, Memphis, Tenn., KFSM-TV, Fort Smith, Ark., WHNT-TV, Huntsville, Ala., WQXR AM/FM radio, New York, N.Y., and NYT Cable TV, Southern New Jersey.

"Associated Companies: Equity interests in three Canadian newsprint companies (Donohue Malbaie, Inc. - 35%; Gaspesia Pulp and Paper Company, Limited - 49%; and Spruce Falls Power and Paper Company, Limited - 49.5%); Madison Paper Industries (a partnership); and International Herald Tribune S.A. - 33.3%. The three Canadian newsprint companies and the partnership supply the major portion of the annual paper requirements for production of The New York Times."

6. In the section of the 1983 Annual Report listing The New York Times Company's directors, officers and executives, the classification of petitioner's business is reflected in the listing of "Operating Group Officers and Executives" which shows a breakdown into the following four operating groups: (1) The New York Times, (2) Regional Newspapers, (3) Magazines, and (4) Broadcasting.

7. A review of the 1983 Annual Report discloses that 1983 was a record year for petitioner in terms of all financial measures: consolidated revenues, net income, total assets, common stockholders' equity per share, dividends per share of common stock and stock price at year-end. The years at issue were years of strong growth, as shown in the following comparisons:

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Consolidated revenues | $841,707,000.00 | $933,692,000.00 | $1,091,302,000.00 |
| Net income | 49,970,000.00 | 54,257,000.00 | 78,668,000.00 |
| Total assets[3] | 598,865,000.00 | 761,479,000.00 | 774,189,000.00 |

Key financial ratios improved significantly:

| Key Ratios | 1981 | 1982 | 1983 |
|---|---|---|---|
| Operating profit to revenues | 7% | 9% | 14% |
| Net income to revenues | 6% | 6% | 7% |
| Return on average stockholers' equity | 18% | 17% | 21% |
| Return on average total assets | 9% | 9% | 10% |
| Long-term debt to total capitalization | 25% | 31% | 16% |
| Current assets to current liabilities | 1.2 | 1.1 | 1.0 |

Operating profits doubled from newspapers and moved generally higher in other areas:

| Operating Profit (Loss) | 1981 | 1982 | 1983 |
|---|---|---|---|
| Newspapers | $54,100,000.00 | $64,012,000.00 | $130,674,000.00 |
| Magazines | 13,134,000.00 | 23,649,000.00 | 16,365,000.00 |
| Broadcasting/Cable TV | 3,528,000.00 | 2,728,000.00 | 4,936,000.00 |
| Books, Information and Education | (3,051,000.00) | (299,000.00) | 9,396,000.00 |
| Unallocated Corporate Expenses | (9,303,000.00) | (8,531,000.00) | (11,808,000.00) |

A comparison of operating profit to revenues for the newspapers category shows an increasing operating margin:

| Revenues | 1981 | 1982 | 1983 |
|---|---|---|---|
| Newspapers | $607,532,000.00 | $674,231,000.00 | $ 833,220,000.00 |
| Magazines | 152,248,000.00 | 169,395,000.00 | 186,354,000.00 |
| Broadcasting/Cable TV | 36,776,000.00 | 46,982,000.00 | 53,380,000.00 |
| Books, Information and Education | 45,151,000.00 | 43,084,000.00 | 18,348,000.00 |
| Total | $841,707,000.00 | $933,692,000.00 | $1,091,302,000.00 |
| Operating Profit Percentage for Newspapers (operating profit divided by revenues) | 8.905% | 9.494%[4] | 15.683% |

8. A review of petitioner's New York corporation franchise tax reports for each of the years at issue shows that it calculated New York franchise tax based upon an allocation of its

[3]Petitioner's tax returns disclose amounts for "total assets" of $561,902,353.00 for 1981, $757,853,811.00 for 1982, and $777,681,714.00 for 1983. The reason for the variance between these amounts and those in the Annual Report is unknown.

[4]Alfred J. Forbes testified that operating margins for The Times were 9%, 12% and just shy of 16% for 1981, 1982 and 1983 (Forbes tr., p. 50). He appears to have made a calculation error for 1982. The annual report noted that lower newsprint prices coupled with revenue increases principally accounted for the improvement in operating margins.

net income to New York (plus allocated subsidiary capital):

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| (i) Allocated net income | $13,540,842.00 | $12,654,498.00 | $38,829,782.00 |
| (ii) 10% of allocated net income | 1,354,084.00 | 1,265,450.00 | 3,882,978.00 |
| (iii) Allocated subsidiary capital | 19,806,904.00 | 30,096,221.00 | 15,677,358.00 |
| (iv) 00.09% of allocated subsidiary capital | 14,110.00 | 17,826.00 | 27,087.00 |
| Net tax[5] | $ 1,371,910.00 | $ 1,292,537.00 | $ 3,897,088.00 |

9. In allocating its income to New York, petitioner used business allocation percentages of 75.58073% for 1981, 55.67675% for 1982, and 52.11934% for 1983. The decline in its business allocation percentage over the three years in issue is primarily rooted in a dramatic increase in receipts from services provided outside New York as reflected in Appendix A.

10. As noted in Finding of Fact "3", the basis for the deficiency notices issued against petitioner is the determination by the Division that petitioner must file combined tax reports with its subsidiary, The New York Times Sales, Inc. ("Sales Inc."). Sales Inc., which is incorporated in the State of Delaware, is a wholly-owned subsidiary of The New York Times Company.

Sales Inc. was established in 1956 in the aftermath of the Alabama Supreme Court's decision in Sullivan v. Times[6] (273 Ala 656, 144 So 2d 25) awarding $500,000.00 in damages against petitioner for libel. According to the testimony of Michael E. Ryan, petitioner's former corporate counsel and currently a senior vice-president, Sales Inc. was established to insulate petitioner from libel actions in jurisdictions outside New York. Sales Inc. was given responsibility for all sales and distribution of The New York Times newspaper and the sale of advertising outside the New York metropolitan area:

> "We were advised at that time in order to not have the same problem in the future in other states that we really ought to structure ourselves so that we have the sales, the circulation and advertising activities in a separate corporation, which was

[5] Net tax was calculated by adding lines "(ii)" and "(iv)" above.

[6] In that case, 20 civil rights advocates, all but two of whom were clergymen in various southern cities, had purchased an advertisement in The New York Times which contained minor misstatements including one that Dr. Martin Luther King had been arrested seven times in Montgomery, Alabama. In fact, Dr. King had been arrested four times. Petitioner was found subject to the Alabama court's jurisdiction because it had sold 66 copies of The New York Times newspaper containing the advertisement in the State of Alabama. The Alabama court's decision was reversed in the famous 1964 case of New York Times Co. v. Sullivan (376 US 254).

> the Sales Corporation, and that we leave the news gathering function in The New York Times Company . . . because they were exempt in just about all of the states . . ." (Ryan tr., p. 186).

Consequently, anyone seeking to sue petitioner for libel would, more than likely, be compelled to maintain litigation in New York, with New York law applying. Petitioner took care to ensure that Sales Inc. maintained a distinct corporate identity with its own directors and officers although they were petitioner's employees.

11. Sales Inc. filed separate New York corporation franchise tax reports for each of the years at issue. It calculated tax based upon an allocation of its net income to New York:

| | 1981[7] | 1982[8] | 1983 |
|---|---|---|---|
| Allocated net income | $88,157.00 | $461,076.00 | $9,049.00 |
| Net tax: | | | |
| 10% of allocated net income | 8,816.00 | 46,108.00 | 905.00 |

12. In allocating its income to New York, Sales Inc. used business allocation percentages of 2.7506% for 1981, 4.83868% for 1982, and .07976% for 1983. The substantial decline in the subsidiary's business allocation percentage in 1983 was primarily the result of the elimination of rental real estate and any employees in New York as reflected in Appendix B.

13. Petitioner concedes that it and Sales Inc. were engaged in a unitary business and that there were substantial intercorporate transactions between them during the years at issue. Nonetheless, it contends that the substantial intercorporate transactions between the two were at "arm's length" so that separate reporting would not distort petitioner's taxable income in New York.

14. The auditor noted in his audit report concerning petitioner[9] (Div. Ex. "J") dated March 17, 1989 that, in his opinion, permitting petitioner to file separately from Sales Inc.

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[7]The photocopy of the 1981 tax return is of poor quality with typed entries crossed out and handwritten numbers substituted. It appears that an auditor made such changes based upon incorrect math used by Sales Inc. in calculating its business allocation percentage for 1981. Amounts as reported have been used above.

[8]Petitioner filed an amended return for 1982 increasing its allocated net income from $382,815.00 to the $461,076.00 shown above.

[9]This audit report noted 385.50 "total hours" expended by the auditor on the audit. A second audit report concerning Sales Inc. which is undated (Div. Ex. "K") shows expenditure of 75 hours by the auditor.

would result in a distortion of petitioner's income:

> "In determining the area of 'distortion', this area also qualifies the company for combined filing. Excluding 'Sales' from the combined report would be distortionary. If the principal business activity of the taxpayer is the publishing and sale of the newspaper, to exclude the solicitation [of advertising] and circulation outside the New York area and the publication and sale of the National Edition would distort the business activities of the company."

Included in the audit report is an undated memorandum from the auditor to an employee of the Division involved with a so-called "committee on combined reports" that further elaborated upon the auditor's position:

> "Although no clear cut definition exists as to what constitutes distortion, I feel our argument has merit. When taking a broad overview of taxpayer's business, we can establish that the taxpayer's line of business is the production of newspapers, specifically under the title the New York Times. Included in the production of a newspaper are several functions which include Circulation, Advertising, Editing, Printing and Distribution to name a few. Therefore, since Sales solicits Advertising and Circulation and Prints and Distributes the National Edition of the New York Times, to exclude the Sales Company would be distortionary to the total business of the Times."

However, the audit report did not address the issue of whether the transactions between petitioner and Sales Inc. were at "arm's length". During the audit, petitioner provided the auditor with a copy of an agreement dated December 31, 1980 entitled "Circulation and Advertising Agreement between The New York Times Company and The New York Times Sales, Inc." (part of Div. Ex. "L"). The auditor pointed to this circulation and advertising agreement in support of the Division's position that there were substantial intercorporate transactions between petitioner and Sales Inc. On cross-examination, the auditor testified that he "believed" he reviewed "the method of expense and income attribution [to Sales Inc.]" that was attached to the agreement (tr., p. 68). The auditor also "believed" that he and his supervisors made a determination that the method of attributing expenses and income to Sales Inc. was at "arm's length", but then he appeared to backtrack in his testimony:

> Auditor: "It's really difficult to remember. I believe that we did make a determination that they were arm's length."
>
> Attorney Arthur Rosen: "That they were arm's length?"

Auditor: "But I don't remember, I really don't." (Tr., pp. 68-69.)

On his later redirect (tr., p. 77) and recross testimony (tr., p. 82), the auditor further backtracked on his initial response that attribution of expenses and income to Sales Inc. was at arm's length. He ultimately agreed with opposing counsel's suggestion that "no investigation was ever made whether or not the agreement resulted in arm's length pricing" (tr., p. 82).

15. The circulation and advertising agreement between petitioner and Sales Inc. provided, in substantive part, as follows:

> "1. Sales, Inc. is retained by The Times for the purpose of developing the circulation growth of The New York Times throughout the United States except in New York particularly through home delivery, and to that end Sales, Inc. will furnish the following services to The Times:
>
> "(a) Hiring and training of sales persons and canvassers and co-ordinating of sales and promotion activities with individual home delivery routes;
>
> "(b) Supervising the distribution of papers through wholesalers to the route carriers;
>
> "(c) Maintaining complete daily and Sunday circulation records and making regular reports to The Times.
>
> "The compensation of Sales, Inc. for its services and the expenses attributable to such services under this paragraph will be determined annually in accordance with a schedule to be prepared no later than 30 days from the date hereof and attached as Exhibit A hereto.
>
> "2. Sales, Inc. is also retained by The Times for the purpose of soliciting advertising throughout the United States, except in New York, for publication in The New York Times. The compensation of Sales, Inc. for its services under this paragraph and expenses attributable to such services will be determined annually in accordance with a schedule to be prepared no later than 30 days from the date hereof and appended hereto as Exhibit A.
>
> "3. The Times is retained by Sales, Inc. for the purpose of providing legal, tax, accounting and other services to Sales, Inc. as and when requested."[10]

Appended to the circulation and advertising agreement, which consists of less than 2½ pages, are two additional sheets. The first sheet, which was photocopied so that the heading is cut off, but which presumably is the so-called "Exhibit A", provided as follows:

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[10] It is noted that the body of the agreement does not explicitly specify that Sales Inc. will reimburse petitioner for such services, although the use of the term "retain" implies that some payment or reimbursement will be made by Sales Inc. for such services.

"The New York Times Sales, Inc. ('Sales, Inc.') shall reimburse The New York Times Company ('The Times') for all expenses attributable to the advertising and circulation of The New York Times Newspaper, including but not limited to: paper and ink, editorial, news, pre-press production, composing/ photoengraving, distribution, mail and delivery, press/stereo/night paperhandlers/maintenance, manufacturing, outside printing and binding, operating overhead, advertising and consumer marketing promotional expenses.

"Income allocated to Sales, Inc. shall be advertising branch office linage times the average rate per line plus circulation from the branch office times the net price per copy. Based upon determination of the percentage of operating expenses to revenues, that percentage of Times Sales revenue shall be allocated as operating expense. These are in addition to the expenses of rent, utilities and payroll, already reflected on the accounts of Sales, Inc."

The second sheet attached to the circulation and advertising agreement is labeled "Allocation to New York Times Sales Co. [sic]" and provides as follows:

"1. Advertising Revenue Allocated to Times Sales[11]

". Branch office linage x average rate per line

"2. Circulation Revenue Allocated to Times Sales

". Average net paid circulation from branch x approx. net price/copy (for daily & Sunday)

"3. Expenses Allocated to Times Sales

". Paper & Ink, Editorial, News, Pre-Press Production, Composing/Photoengraving, Distribution, Mail & Delivery, Press/Stereo/Night Paperhandlers/Maintenance, Manufacturing, Outside Printing & Binding, Operating Overhead, Advertising & Consumer Marketing Promotional Expenses.

". Based on 11 months of 1980, these expenses accounted for 75% of revenue.

"Pt Allocation percentage for 1981 will be based upon budget performance. Will be recorded quarterly. Percentage adjusted at year-end, if material.

"4. <u>Allocated to Times Sales</u>:

"A. Income

"(1) Advertising branch office linage x average rate/line.

"(2) Circulation from branch x net price/copy.

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[11] It is somewhat odd that in the so-called Exhibit A, New York Times Sales Corp. is referred to as Sales, Inc., while on this other sheet it is referred to as Times Sales. The variance supports a finding that the two sheets were either not prepared by the same person or were prepared at different times.

"B. Expenses

"(1) 75% of above revenue was allocated as operating expenses.

"(2) Expenses of branch office (rent, utilities, payroll) are already reflected on books of Times Sales."

16. Petitioner presented two witnesses, Alfred J. Forbes and Siv Janger, in support of its position that it should not be required to file a combined report with its subsidiary, Sales Inc.

17. Alfred J. Forbes, a certified public accountant, has been an employee of petitioner since April 1983 and is currently involved in the design of new financial reporting systems in a managerial position. He testified that he became familiar with Sales Inc. "[f]irst, in connection with the audit work I performed while with Deloitte[12] and then as part of my work for The New York Times newspaper" (Forbes tr., p. 7). Petitioner was an audit client of the Deloitte accounting firm, and Mr. Forbes participated in the audit of petitioner during the period at issue:

> "My first knowledge of Sales came as part of the audit of The New York Times newspaper. We had a procedure called APT, which is transaction testing. We select debits, journal entries, essentially, from the general ledgers of The New York Times Company, the New York Times Sales Company [sic], a variety of companies, subsidiaries of The New York Times Company, The Times.
>
> "Among those selections were a number of the entries recording revenues and expenses for the Sales Company [sic]" (Forbes tr., p. 8).

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

> 18. Mr. Forbes executed an affidavit dated October 21, 1992 (Pet. Ex. "132"). The affidavit states that it was prepared "to provide the court with a summary [Mr. Forbes] provided Ms. Janger, and succinctly to summarize his testimony . . ." It was submitted into evidence after his

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[12]Petitioner's annual report for 1983 includes an auditors' opinion of Deloitte Haskins & Sells dated February 16, 1984 reflecting the fact that Mr. Forbes' prior employer audited the consolidated balance sheets of petitioner and its subsidiaries and certified petitioner's financial statements. The auditors' opinion provided as follows:

> "We have examined the consolidated balance sheets of The New York Times Company and subsidiaries as of December 31, 1983 and 1982 and the related consolidated statements of income, stockholders' equity, and changes in financial position for each of the three years in the period ended December 31, 1983. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> "In our opinion, such consolidated financial statements present fairly the financial position of the companies at December 31, 1983 and 1982 and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1983, in conformity with generally accepted accounting principles applied on a consistent basis."

examination under oath (which was conducted outside the presence of the Administrative Law Judge). The Division's representative objected to the introduction of the affidavit on the grounds that she did not see the necessity of the affidavit or find it necessary or relevant. In the affidavit, Mr. Forbes summarized his videotaped testimony concerning the attribution of income and expenses to Sales Inc. pursuant to the advertising and circulation agreement. Mr. Forbes testimony dealt with matters not covered by the technical wording of the circulation and sales agreement.[13] For example, the responsibility of Sales Inc. to produce the national edition of The New York Times was not even mentioned in the agreement. Mr. Forbes opined that "production of the paper is implied" by the obligation of Sales Inc. "to deliver a paper at someone's home in time for them to take it with them to work" (Forbes tr., p. 70). Additionally, charges by petitioner to Sales Inc. for management and supervisory charges were not mentioned in the agreement. Mr. Forbes suggested an explanation for such omission:

> "A parent does not need a contractual right to -- from the standpoint of consolidated financial statements or from the standpoint of tax reporting to allocate the expenses to a subsidiary" (Forbes tr., p. 115).

The succinctness of Mr. Forbes' affidavit (10 pages) represented a clearer statement[14] than his testimony (152 pages). First, he described the activities of Sales Inc. succinctly as follows:

> "During the years 1981 and 1982, the business of Sales consisted of three activities: (i) selling advertising for the Newspaper in all parts of the country except the Time's primary marketing area, consisting of the New York metropolitan area and the area within a radius of approximately 50 miles from New York City, (ii) production and circulation of the national edition of the Newspaper outside the northeast corridor, and circulation within the northeast corridor (but excluding the Times's primary marketing area) of copies of the Newspaper produced by the Times, and (iii) operation of a news service (the 'News Service') that marketed news stories and other materials produced by the Times to third parties. In 1983, Sales continued operating its advertising and circulation businesses but did not operate the News Service."

The 1983 annual report noted that the press run for the National Edition was approximately 100,000 copies on weekdays and 200,000

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Mr. Forbes' knowledge of the agreement appears to have been secondhand. The agreement was signed by petitioner's corporate secretary, Solomon B. Watson, IV, on behalf of Sales Inc. by its vice-president, Benjamin Handelman (who is also described in the 1983 annual report as petitioner's senior vice-president, and deputy to the president). Mr. Forbes was not responsible for the drafting or development of the agreement. It is unknown who was so responsible. It is fair to say that Mr. Forbes, as a certified public accountant and auditor, was more of an interpreter or reviewer of the agreement and the arrangement between petitioner and Sales Inc. than someone with personal involvement in the development of such agreement and arrangement.

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It should be noted that there do not appear to be any inconsistencies between Mr. Forbes' testimony and his statements in his affidavit.

copies on Sundays. The 1983 unaudited circulation of the Times was 934,600 copies on weekdays and 1,543,300 copies on Sundays. The annual report noted the following general breakdown of the paper's geographic distribution:

> "Approximately 75% of the weekday circulation is sold in New York City, its suburbs and certain adjacent areas and 25% is sold elsewhere. On Sundays, approximately 67% of the circulation is sold in New York City, its suburbs, and certain adjacent areas and 33% elsewhere."

The Form 10-K filed by petitioner with the Securities and Exchange Commission (Pet. Ex. "129") indicated that during the years at issue the National Edition was distributed from three printing sites: in the midwest from a Chicago site, in the southeast from a Lakeland, Florida site, and in the southwest from a Torrance, California site. Satellite transmission of page images to the printing plants made early morning delivery of the newspaper possible.[15]

19. Mr. Forbes' affidavit also included the following coherent description of the revenues of Sales Inc.:

> "9. The revenues of Sales . . . for 1981 and 1982 included three components: (i) all advertising revenues attributable to customers located in the territories serviced by the branch offices of Sales; (ii) circulation revenues derived from total circulation of the national edition of the Newspaper and from circulation of the Newspaper within the northeast corridor (but excluding the Times' primary marketing area); and (iii) all revenues attributable to the activities of the News Service. The revenues of Sales . . . for 1983 include the first two of these components, but do not include any revenues from the activities of the News Service."

We modify finding of fact "20" of the Administrative Law Judge's determination to read

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We modified the first and third paragraphs of finding of fact "18" of the Administrative Law Judge's determination in order to more correctly reflect the record. The paragraphs read as follows:

> "In an affidavit dated October 21, 1992 (Pet. Ex. '132') submitted after his examination under oath (which was conducted outside the presence of the Administrative Law Judge), Mr. Forbes clarified his less than coherent videotaped testimony concerning the attribution of income and expenses to Sales Inc. pursuant to the advertising and circulation agreement. It is noted that part of the cause for the confusing nature of his testimony under oath is the skimpy nature of this central agreement which he was called upon to explain [footnote 13]. For example, the responsibility of Sales Inc. to produce the national edition of The New York Times was not even mentioned in the agreement. Mr. Forbes opined that 'production of the paper is implied' by the obligation of Sales Inc. 'to deliver a paper at someone's home in time for them to take it with them to work' (Forbes tr., p. 70). Additionally, charges by petitioner to Sales Inc. for management and supervisory charges were not mentioned in the agreement. Mr. Forbes suggested an explanation for such omission:"

> "In any event, Mr. Forbes' affidavit, submitted after his examination under oath, represented a much clearer statement [footnote 14] than his testimony. First, he described the activities of Sales Inc. succinctly as follows:"

as follows:

> 20. Mr. Forbes' affidavit also clearly described the expenses of Sales Inc. in the following paragraphs:
>
> "10. For the years 1981 and 1982, the expenses of Sales . . . fall into five major categories . . . .
>
> "11. The first category of expenses consists of Sales's direct costs of operating its advertising and circulation businesses, including all direct costs of maintaining Sales's branch offices and employee work force, all costs of receiving the editorial content of the Newspaper from the Times and producing and delivering the national edition of the Newspaper after receipt of the editorial content from the Times, and all costs of delivering the Newspaper within the northeast corridor (but excluding the Time's primary marketing area) after receipt of the Newspaper from the Times.[16]
>
> * * *
>
> "15. The second category of Sales's expenses was a management and supervisory charge[17] which the Times charged to Sales to cover various administrative services that the Times performed for Sales. The management and supervisory charge was calculated using a formula that took into account the operating pre-tax net income and gross revenues of the Times and each of its subsidiaries . . . .
>
> "16. The third category of Sales's expenses was an advertising and circulation sales service charge[18] intended to reimburse the Times for a portion of costs of preparing and producing the Newspaper . . . .

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16

In paragraphs "12", "13" and "14" of his affidavit, Mr. Forbes pinpointed where in the tax returns of Sales Inc. these direct costs of operating its advertising and circulation businesses were reported for 1981, 1982 and 1983, respectively.

17

Mr. Forbes, in his affidavit, pinpointed where in the 1981 and 1982 Federal tax returns these expenses were reported. He did not reference the 1983 return, but in reviewing petitioner's Exhibit "131", which is a photocopy of the 1983 Federal tax return, it is observed that a deduction for a management and supervisory charge of $1,715,555.00 is shown on Statement 2 of the return. Such charges for 1981 consisted of $2,435,665.00 described as "M & S charges by N.Y.T. Co." under the heading "The New York Times Sales, Inc. - Div" and of an amount of approximately $500,000.00 under the heading "The New York Times Sales, Inc. - News Sevs Div". The photocopy of Statement 6 to the 1981 tax return is of such poor quality that the specific amount cannot be deciphered. Such charges for 1982 consisted of $515,213.00 "M & S charges by N.Y.T. Co." under the heading "The New York Times Sales, Inc. - Div" and of $505,199.00 under the heading "The New York Times Sales, Inc. - News Sevs Div". There was only one amount representing "M & S charges" for 1983 because, as noted in Finding of Fact "18", in 1983 Sales Inc. did not operate the news service.

18

Mr. Forbes noted that, in each of the Federal tax returns for the years at issue, these expenses were reported as part of the cost of goods sold of Sales Inc. and were reflected in a detailed description of cost of operations that was included in each return. The returns show sales service charges of $47,828,848.00, $52,159,514.00 and $57,176,760.00 for 1981, 1982 and 1983, respectively.

"17. The sales service charge for advertising and circulation was determined by multiplying certain of Sales's advertising and circulation revenues by the gross cost percentage for the Newspaper. For purposes of this calculation, the gross cost percentage was the ratio of (i) the sum of the Times' cost of materials (i.e. paper and ink), operating expenses (i.e. editorial, news, distribution, outside printing and binding, overhead, and other operating costs), advertising and consumer marketing, to (ii) total revenues from advertising and circulation of the Newspapers produced by the Times.

"18. To calculate the advertising and circulation sales service charge, the gross cost percentage described above was applied against the sum of (i) all advertising revenues attributable to Sales, except revenues for certain classified advertising appearing in the national edition (in particular, 'display advertising' appearing only in the national edition, and 'repeat advertising' appearing in the national edition), and (ii) circulation revenues derived from distribution of the Newspaper within the northeast corridor (but excluding the Times' primary marketing area). Sales's circulation revenues from the distribution of the national edition of the Newspaper were excluded from the base used to calculate the advertising and circulation sales service charge . . . .

* * *

"20. The fourth category of expenses consists of reimbursement to the Times for all expenses specifically attributable to the News Service, including salaries, benefits, rents, printing, data processing, communication costs, and other such expenses[19]. . . .

---

[19] Mr. Forbes did not reference one specific line in the Federal tax returns on which such expenses were reported. Rather, he noted that such "expenses are reflected on Form 1120, Statement 2, Line 2 and Lines 12 through 25 and part of Line 26." These lines show the following:

| "Line | Description | Line<br>1981 | 1982 | |
|---|---|---|---|---|
| 2 | Cost Goods Sold/Op | | $ 909,454.00 | $ 696,014.00 |
| 12 | Compensation offcr | | 129,227.00 | 134,430.00 |
| 13 | Salaries and Wages | | 261,375.00 | 233,005.00 |
| 14 | Repairs | 12,031.00 | 19,130.00 | |
| 15 | Bad debts | 106,048.00 | 92,230.00 | |
| 16 | Rents | | 71,232.00 | 105,914.00 |
| 17 | Taxes | | 114,684.00 | 75,466.00 |
| 18 | Interest expense | -- | -- | |
| 19 | Contributions | -- | -- | |
| 20 | Amortization | -- | -- | |
| 21 | Depreciation | 15,008.00 | 11,244.00 | |
| 22 | Depletion | -- | -- | |
| 23 | Advertising | 26,667.00 | 21,091.00 | |
| 24 | Pension profit shr | | 16,711.00 | -- |
| 25 | Other ben. plans | 9,045.00 | 58,994.00 | |
| 26 | Other deductions | 2,445,668.00 | 2,777,552.00 | |

> "21. The fifth category of expenses consisted of a royalty paid by Sales to the Times for the use of news materials produced by the Times and resold through the News Service.[20] The royalty was equal to 45% of Sales's operating profit attributable to the sale of the Time's material by the News Service . . . ."
>
> The News Service Agreement (Pet. Ex. "116") between petitioner and Sales Inc. granted Sales Inc. an exclusive license to sell the News Service to subscribers. Sales Inc. was required to reimburse petitioner "for all expenses attributable to the News Service . . . . In addition, for use of New York Times material, [Sales Inc.] shall pay a royalty of 45% of its operating profit, less excludable amounts attributable to the use by [Sales Inc.] of material not obtained from [petitioner] nor related to The New York Times newspaper" (Pet. Ex. "116").
>
> Mr. Forbes testified that he did not "know the basis for determining the rate" but that the royalty was for the copyrighted news information produced by petitioner which is being resold by Sales Inc. to subscribers.[21]

21. There is an overwhelming interdependence between petitioner and Sales Inc. Sales Inc. never sold advertising for anyone other than petitioner according to Mr. Forbes, who rejected the suggestion by petitioner's counsel that Sales Inc. sold an advertising package covering other newspapers in different markets than petitioner (Forbes tr., p. 18). Petitioner checked the creditworthiness of all advertisers and performed billing functions for Sales Inc. Circulation revenues were, according to Mr. Forbes, "[o]n a daily basis, those funds are swept out of the lock box accounts [of Sales Inc.] into a concentration account [of petitioner's] here in New York" (Forbes tr., p. 25). Accounting, legal and tax services were all performed by petitioner's employees for Sales Inc. Furthermore, marketing campaigns and advertising

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| Lines 12-26 Total | $3,207,696.00 | $3,529,056.00" |
|---|---|---|

[20] Mr. Forbes referenced Statement 6 in the line called "Sales Service Miscellaneous From Corp." for the royalty paid by Sales Inc. to petitioner in 1981. The amount on the poor photocopy appears to be over $1,000,000.00, but is not easily decipherable. For 1982, such expense amounted to $1,907,681.00.

[21] We modified finding of fact "20" of the Administrative Law Judge's determination by adding the last two paragraphs and by deleting a footnote which appeared in the last sentence of paragraph "21" after the phrase "was equal to 45%." The footnote read as follows:

> "Mr. Forbes testified that he did not 'know the basis for determining the rate' (Forbes tr., p. 40). A so-called news service agreement dated December 31, 1980 between petitioner and Sales Inc. set the royalty at 45% and also requires Sales Inc. to reimburse petitioner for all expenses attributable to the news service."

strategies were developed mostly by petitioner. A telling indication that petitioner and Sales Inc. were interdependent is the following (albeit incorrect) response by Lance Primis, president and general manager of The New York Times (the newspaper division of petitioner, which is The New York Times Company [emphasis added]):

> Attorney Rosen: "Let me ask a question I asked you earlier in a different way. Are you familiar with the relationship between The New York Times Company and the Sales Company?"
>
> Mr. Primis: "The New York Times -- the Sales Company is a division of The New York Times Company" (Primis tr., p. 42; emphasis added).

22. Mr. Forbes testified that the net income of Sales Inc. as a percentage of its total expenses was approximately 4%, which he noted was reasonable in comparison to petitioner's New York newspaper wholesalers. In concluding his direct examination, Mr. Forbes opined that the financial arrangement between petitioner and Sales Inc. was at arm's length.

### *THE TESTIMONY OF EXPERTS*

23. Petitioner presented the testimony of Siv Janger, a manager at the firm of Coopers & Lybrand. Ms. Janger, an economist, was qualified as an expert who had expertise in the publishing industry and in transfer pricing, especially the practical application of Internal Revenue Code § 482. Ms. Janger had been previously employed as an industry economist by the Internal Revenue Service. She was familiar with the arrangement between petitioner and Sales Inc. based on interviews of several employees of petitioner and a review of documents including the Federal tax returns and workpapers for The New York Times Company and Sales Inc., the circulation and advertising agreement as detailed in Finding of Fact "15", the news service agreement as noted in footnote "20", the methodology used to allocate costs between petitioner and Sales Inc., the affidavit of Alfred J. Forbes quoted at length in Findings of Fact "18", "19" and "20", 10-K reports for certain newspaper companies, and a report prepared by the Division's expert, Mr. Arthur Friedson. Ms. Janger also prepared a report summarizing her analysis and conclusions, which was received in evidence as petitioner's Exhibit "133".

24. The crux of Ms. Janger's testimony was that, from an economic perspective, petitioner and Sales Inc. were engaged in a cost-sharing arrangement for the development of an

intangible, namely the editorial content of The New York Times newspaper, and that, judged by the standards of Internal Revenue Code § 482 ("section 482"), this cost-sharing arrangement was the equivalent of an arm's-length transaction. She based this opinion on three essential findings: first, the editorial content of the newspaper constituted an intangible; second, petitioner and Sales Inc. were engaged in a good-faith effort to share costs associated with the development of the editorial content of the newspaper -- that is, that there was no effort to evade taxation; and third, that these costs were shared proportionately in relation to the benefits each party anticipated receiving from the exploitation of the editorial content. Ms. Janger's opinion was that, from an economic perspective, the arrangement between petitioner and Sales Inc. was a good-faith, cost-sharing arrangement that would qualify as the equivalent of an arm's-length transaction under section 482.

25. Ms. Janger also emphasized that, based on a comparison of the operating margins of petitioner and Sales Inc. with each other and with other relevant newspaper publishing companies, there was no indication of income shifting from petitioner to Sales Inc. The operating margins for both corporations fell well within the range of the sample group's operating margins. In particular, Ms. Janger noted that petitioner's operating margin was markedly similar to that of The Washington Post, the newspaper in the sample group with characteristics most similar to those of The Times.

26. The Division presented the expert testimony of Arthur Friedson, an economist and an employee of the Office of Tax Policy Analysis (the Division's research arm), regarding the relationship between petitioner and Sales Inc. The Division also submitted in evidence a report prepared by Mr. Friedson (Div. Ex. "M").

Mr. Friedson, who has been involved in a so-called "combined reporting study" for the Division, did not have any prior experience with the publishing industry. He did not profess to any expertise regarding the concept of cost-sharing arrangements under section 482, and from his review of the circulation and advertising agreement and "some looking at the tax returns" (tr., p. 610), Mr. Friedson would not conclude that petitioner and Sales Inc. were engaged in joint cost sharing in the development of an intangible, i.e., the editorial content of the newspaper.

We modify finding of fact "27" of the Administrative Law Judge's determination to read as follows:

> 27. Mr. Friedson indicated that, in his opinion, petitioner's income would be distorted by the filing of separate tax reports by petitioner and Sales Inc. because:
>
> (i) Sales Inc. was permitted to use the trade name, The New York Times, without any compensation to petitioner;
>
> (ii) Petitioner's relationship with its wholly-owned subsidiary enabled it to avoid substantial costs it otherwise would have incurred to ensure quality control and avoid debasement of its trade name;
>
> (iii) The absence of any markup for materials such as paper and ink in the circulation and advertising agreement provided evidence of distortion;
>
> (iv) Under the circulation and advertising agreement, the allocation of income to Sales Inc. was wholly dependent on petitioner's activities, indicating an inequality of bargaining power between the two; and
>
> (v) The two companies were part of a vertically integrated business, suggesting a distortion of income between the two companies due to savings of transaction costs that would have been incurred in dealing with unaffiliated parties.
>
> Mr. Friedson testified that petitioner and Sales Inc. shared expenses and revenues. In response to the question of whether profits were being shared, he responded: "[t]hat is not as easy to detect, but it would appear that based on the sharing of revenues and expenses that profits would be" (Tr., p. 609). Mr. Friedson further testified that in order to determine if there is an arm's-length arrangement, it is important to look at the nature of the agreements "the plain reading of the agreement or a reading of the agreement as implemented and as the cost and expenses were actually shared and reflected on the tax returns" (Tr., p. 610). He indicated that "[u]nfortunately, all I had was the plain reading of the agreement and some looking at the tax returns that can't, I could not always detect what was happening from the tax returns" (Tr., p. 610).
>
> Petitioner's expert agreed with Mr. Friedson's observations as to how to determine if there was an arm's-length arrangement and indicated that she followed the approach described by Mr. Friedson (Ex. "133," p. 10). She responded as follows to each of Mr. Friedson's points:
>
> (i) Because the value of the trade name, The New York Times, was based upon the accumulated value of the quality of the editorial content together with enhancements in value resulting from advertising for the newspaper itself, and because all costs associated with the development of the editorial content and the newspaper's marketing activities were included in the pool of shared costs under the arrangement between petitioner and Sales Inc., it would be improper and contrary to the cost-sharing approach to require Sales Inc. to pay any separate amount for the use of petitioner's trade name;

(ii) Petitioner's relationship with Sales Inc. did not result in any substantially enhanced benefits in the area of quality control. The editorial content of the newspaper was wholly within the control of petitioner and it could easily have had the same arrangement for transmission of editorial content with a third party as it had with Sales Inc. In addition, petitioner's relationship with Sales Inc. did not affect the risk of debasement of the trade name or quality control problems in the area of distribution, since Sales Inc. ultimately contracted with third parties for these services;

(iii) Petitioner's costs for paper and ink were already included in the cost-sharing arrangement, and since all costs of production were shared equitably, it would be inappropriate for petitioner to charge any additional markup for these items;

(iv) Allocations of revenue to Sales Inc. were not dependent on activities of petitioner. Rather, they were dependent on the volume of advertising and circulation sales achieved by Sales Inc. itself, factors outside petitioner's control. Moreover, the mere presence of unequal bargaining power between petitioner and Sales Inc. did not demonstrate distortion, since unequal bargaining power is often present in relationships between unaffiliated parties; and

(v) The relationship between the corporations did not result in savings of transaction costs, as Mr. Friedson suggested, because petitioner was already engaged in every activity conducted by Sales Inc., and did not need to integrate with Sales Inc. in order to overcome inefficiencies in bargaining with third parties. Petitioner's relationship with Sales Inc. did result in economies of scale, particularly from the concentration of editorial functions and the physical production of newspapers in petitioner, but these cost savings did not result in any distortion of income, since all such costs were included in the cost-sharing formula and were shared equitably by the two.[22]

***OPINION***

In its exception, the Division identifies two issues:

"1 Did the petitioner meet its burden of proof to overcome the presumption of distortion between Times and Sales?

"2. Did the Administrative Law Judge err in utilizing the affidavit of Alfred J. Forbes to rehabilitate the earlier testimony of Mr. Forbes?" (Division's brief, p. 11).[23]

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22

We modified finding of fact "27" of the Administrative Law Judge's determination by adding the second paragraph concerning Mr. Friedson's testimony in order to more fully reflect the record.

23

The Division has excepted to that portion of the Administrative Law Judge's determination in which he concluded that the Division could not require petitioner to file a combined report with Sales Inc. The Division did not except to that portion of the determination which concluded that petitioner should be allowed to file on a combined basis with Northern SC Paper Corp.

We deal first with the Division's assertion that "there is no rational basis to find that the affidavit of Mr. Forbes, which was not subject to cross examination, should be given more credence than his sworn testimony, which was subject to cross examination" (Division's brief, p. 22).

We cannot agree. First, we point out that affidavits may be received into evidence in a hearing for whatever value they may have in lieu of oral testimony of the person making the affidavit (20 NYCRR 3000.10[d]). Mr. Forbes' affidavit was prepared to assist Ms. Janger with her expert testimony. It was made necessary by the fact that a transcript of Mr. Forbes' testimony (which was videotaped on October 16, 1992) was not prepared in time for the October 22, 1992 hearing at which Ms. Janger was to testify. (In fact, the transcript is dated October 27, 1992.) The affidavit related only to the financial aspects of the relationship between petitioner and Sales Inc. about which Mr. Forbes had testified and about which Ms. Janger would testify. It was, in essence, a distillation (10 pages) of that portion of Mr. Forbes' testimony (152 pages) relevant to Ms. Janger's testimony.

Next, we find no merit to the Division's assertion that the Administrative Law Judge gave more credence to Mr. Forbes' affidavit than to his sworn testimony to the disadvantage of the Division. The Administrative Law Judge found that there did not appear to be any inconsistencies between Mr. Forbes' testimony and his statements in his affidavit. We concur. Further, the Division has not pointed out any such inconsistencies. In other words, the content of the testimony and the affidavit are substantively the same. Accordingly, we find no error in the Administrative Law Judge's reliance on the affidavit for his findings of fact concerning the relationship between petitioner and Sales Inc. (cf., Matter of Orvis Co. v. Tax Appeals Tribunal, ___ NY2d ___ [June 14, 1995] [where the Court of Appeals upheld the Tribunal's rejection of statements in the petitioner's affidavits because they were inconsistent with prior correspondence between the petitioner and the Division]).

We deal next with the Division's assertion that petitioner has not overcome the presumption of distortion by demonstrating that reporting on a separate basis more properly reflects its New York franchise tax liability.

The Division's regulations (which implement Tax Law § 211[4]) 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 and that separate reporting results in a proper reflection of income (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 Sears, Roebuck & Co., Tax Appeals Tribunal, April 28, 1994 and 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]).

Treasury Regulation § 1.482-2A(d)(4) (which is applicable to IRS audits for tax years beginning after 1986 and before April 22, 1993) provides as follows:

> "Sharing of costs and risks. Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is reduced to writing prior to January 1, 1969." (1994 Standard Federal Tax Reports (CCH), pp. 41,733-41,734, emphasis added to phrase underlined in the body

of the regulation.)[24]

Treasury Regulation § 1.482-2A(d)(3) provides, in relevant part, that for purposes of section 482, intangible property shall consist of:

> "(b) Copyrights, literary, musical, or artistic compositions, and other similar items;
>
> "(c) Trademarks, trade names, brand names, and other similar items."

The Administrative Law Judge determined that petitioner proved that its cost-sharing arrangement with Sales Inc. resulted in the intercorporate transactions between the two companies being conducted on an arm's-length basis in accordance with the standards set by Internal Revenue Code § 482. The Administrative Law Judge first found that petitioner was correct in its position that petitioner and Sales Inc. were benefitting from the editorial content of The New York Times newspaper, which content the Administrative Law Judge found to be an intangible within the meaning of Treasury Regulation § 1.482-2A(d)(3).

In essence, the Administrative Law Judge found that the trade name "New York Times" was inextricably linked to the editorial content of the Newspaper and that it was the use of the tradename "New York Times" from which Sales Inc. benefitted by its sales of advertising and circulation sales. The Administrative Law Judge determined that "if petitioner can show that it and Sales Inc. allocated costs of producing the Newspaper between them in proper relationship to the benefits each received, it must necessarily prevail" (Determination, conclusion of law "J").

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[24] The Administrative Law Judge observed that "the regulations under section 482, as published in the 1994 Standard Federal Tax Reports (CCH), include regulations applicable to tax years beginning on or before April 21, 1993, and which are codified at pages 41,723 through 41,741. These regulations include the letter 'A' to reflect, apparently, that they are a so-called 'A' version of the regulations. The regulations cited in the Tribunal's footnote '27' [in Matter of USV Pharm. Corp., supra] noted in Conclusion of Law 'G' were the 'A' version of the regulations. . . .

"At pages 41,741 through 41,752 of the 1994 Standard Federal Tax Reports (CCH) are the portion of the proposed regulations under section 482 which were issued on January 30, 1992 and which were not subsequently withdrawn. However, the only proposed regulation, which was issued on January 30, 1992, and not subsequently withdrawn was proposed regulation section 1.482-2(g) setting forth cost-sharing provisions" (Determination, conclusion of law "H").

We have updated the observations of the Administrative Law Judge to refer to the 1994 Standard Federal Tax Reports (CCH).

The Administrative Law Judge concluded that:

> "the circulation and advertising agreement, described in detail in Finding of Fact '15,' together with the evidence in the record concerning the agreement's implementation (in particular, the videotaped testimony and affidavit of
>
> Alfred J. Forbes), was sufficient to establish that petitioner and Sales Inc. acted in good faith 'to bear their respective shares of all the costs and risks of development on an arm's length basis' of the newspaper's editorial content.
>
> As noted in Finding of Fact '20' and accompanying footnotes, petitioner has detailed the specific expenses which Sales Inc. incurred and reported on its tax returns so that income was properly reported by petitioner and not shifted to Sales Inc. by manipulating the reporting of expenses. In addition, petitioner's expert, as noted in Finding of Fact '23,' specified the basis for her opinion and concluded that petitioner and Sales Inc. were engaged in a cost-sharing arrangement that was the equivalent of an arm's-length transaction. It is also noted that petitioner's expert successfully countered the particular points raised by the Division's expert, as noted in Finding of Fact '27.'
>
> "It should also be emphasized that, as noted in Finding of Fact '10,' petitioner created Sales Inc. for reasons clearly unrelated to the avoidance of New York tax. Moreover, there is <u>no evidence</u> in the record that Sales Inc. was used by petitioner to shift income out of New York by using its control over Sales Inc. to manipulate revenues and expenses so that income would be shifted to Sales Inc. and expenses to petitioner (<u>cf</u>., <u>Capital District Better TV v. Tax Appeals Tribunal</u>, 200 AD2d 911, 606 NYS2d 930)" Determination, conclusions of law "K" and "L."

The Division asserts that petitioner's relationship with Sales Inc.:

> "was replete with non-arm's length transactions. Management, legal, administrative, tax and accounting services were provided by the petitioner on behalf of Sales without any compensation. Sales made millions of dollars in loans to petitioner without <u>any</u> compensation. In short, it has been demonstrated that the petitioner did not relate to the Sales on arm's-length terms, and thus the financial statements of both corporations do not accurately reflect the costs and income resulting from each corporation's activities . . . " (Division's brief, p. 14).

The Division asserts that "[t]he degree of centralization of management and functional integration . . . that existed between petitioner and Sales was such that <u>it would be impossible to separate, for accounting or tax purposes, the respective contributions made by each company to the value of the enterprise as a whole</u>" (Division's brief, p. 16, empha0sis added).

The Division asserts that:

> "[t]here is no evidence in the record that shows Sales compensated Times for the use of the internationally known tradename and trademark, 'The New York Times'" (Division's brief, p. 18).

The Division's expert, Mr. Friedson, in his report, concluded that:

> "[t]he analysis of the financial agreements, the tax returns and in light of the economic literature leads to the following conclusions:
>
> "1. Sales and Times are a vertically integrated, unitary business.
>
> "2. Certain transactions between Sales and Times were not properly priced.
>
> "3. Other transactions (the loan) and intangible assets were not priced at all.
>
> "Therefore, separate reporting by Sales and Times will certainly inaccurately reflect their income and will lead to an incorrect franchise tax liability. Moreover, placing a value on these transactions, especially the intangible trade name, may be impossible. Thus, combining the returns of Sales and Times will more accurately reflect the income and tax liability of the New York Times Company" (Report of Arthur S. Friedson, November 23, 1992, p. 9).

We affirm the determination of the Administrative Law Judge.

Petitioner and Sales, Inc. were jointly engaged in the production and distribution of the New York Times Newspaper. The cost-sharing arrangement between petitioner and Sales Inc. for this joint enterprise was the equivalent of an arm's-length transaction under section 482 of the Internal Revenue Code and the regulations promulgated thereunder in that it represented a good faith effort by the two corporations to share the costs of their joint enterprise in proportion to the benefits received by each by allocating the costs in proportion to their respective revenues. The Administrative Law Judge found Ms. Janger's expert analysis persuasive. So do we. First, Ms. Janger established a firm base for her analysis. She was familiar with the arrangement between petitioner and Sales Inc. based on interviews with several of petitioner's employees and a review of documents, including petitioner's Federal income tax returns and workpapers, the Circulation and Advertising Agreement, the News Service Agreement, the methodology used to allocate costs between petitioner and Sales Inc., the 10-K reports for certain other newspaper companies, and the report of the Division's expert, Mr. Friedson. She reduced the findings resulting from her analysis to a report introduced into the record in which she concluded that the intercorporate transactions were arm's length (Ex. "133").

On the other hand, the record is clear that the Division, on audit, did not examine the intercorporate transactions to determine if they were at arm's length. It is also clear that the

analysis of the Division's expert was limited, i.e., "[u]nfortunately, all I had was the plain reading of the [cost sharing] agreement and some looking at the tax returns that can't, I could not always detect what was happening from the tax returns" (Tr., p. 610). Finally, we believe the Division's expert misses the point when he focuses on "no profit or markup is built into the compensation agreements . . ." (Division's Exhibit "N,", p. 6). The arrangement is a "cost-sharing" which does not involve a sale by petitioner to Sales Inc. of any tangible or intangible property for which a mark-up would be appropriate. We agree with the Administrative Law Judge that Ms. Janger successfully refuted these assertions (Determination, finding of fact "27").

Second, we agree with Ms. Janger's method of analysis, as did the Division's expert. In brief, Ms. Janger focused on the intent of the arrangement between petitioner and Sales Inc. (i.e., to share the costs of producing The New York Times in relation to the benefits received by petitioner and Sales Inc., respectively); whether it was implemented as intended (i.e., whether the relevant costs associated with the development of The New York Times were shared in proportion to the benefits); and the results of the implementation (Ex. "133," p. 10).

Third, we agree with Ms. Janger that:

> "[a]s to intent, the arrangement provides for the sharing of the operating costs of the Newspaper division of the Times, which include the cost of creating editorial matter such as news gathering, layout and similar costs. This editorial matter is an intangible as defined by the §482 regulations (discussed above). The sharing of these costs is in direct proportion to the benefits earned in utilizing these intangibles since Sales bears these costs in proportion to its revenues. The formula, therefore, appears to be a good faith effort at sharing relevant costs in proportion to benefits received by each company, and thus the first criterion, intent, is satisfied" (Ex. "133,", pp. 10-11).

The Division, in its opposition, offers only mere assertions that the transactions were not arm's length.

Fourth, we are persuaded that the tests performed by Ms. Janger show that the relevant costs associated with the development of the Newspaper were shared in proportion to the benefits received by petitioner and Sales Inc. in accord with the principles underlying section 482. In brief, Ms. Janger, using the tax returns of petitioner and Sales Inc. for each of the years at issue (i.e., 1981, 1982 and 1983), calculated the total cost of producing the Newspaper (e.g.,

$369,656,318.00 in 1983). She then determined the ratio that Sales Inc.'s revenues ($106,395,784.00) bore to the combined total revenues of petitioner's News Division and Sales Inc. ($674,982,491.00). She applied that fraction (16%) to the total cost of producing the Newspaper ($369,656,318.00). The result ($58,267,991.00) was an allocation of petitioner's prorated cost of producing the Newspaper in relation to Sales Inc.'s proportion of the total revenues. This mathematical calculation produced amounts which were slightly lower than the Sales Service Charge from petitioner to Sales Inc. in each of the years as reported on Sales Inc.'s Form 1120. Ms. Janger concluded that this comparison confirmed that petitioner and Sales Inc. "followed the methodology set forth in the agreements" (Ex. "133," p. 12). The Division offers no analysis to controvert Ms. Janger but merely asserts, in substance, that petitioner's relationship with Sales Inc. "was replete with non-arm's-length transactions" (Division's brief, p. 14).

Fifth, Ms. Janger performed a similar test on the Marketing and Service charge by petitioner for the administrative services it provided to Sales Inc. She determined that the allocation of these expenses by petitioner to its operating divisions and subdivisions using a formula based on operating income and gross revenues of the division and subsidiaries was reasonable and in keeping with sound accounting practice and, thus, met the arm's-length requirements of section 482 (Ex. "133," pp. 12-13). Again, the Division offers no analysis to controvert Ms. Janger; it merely asserts that "[m]anagement, legal, administrative, tax and accounting services were provided by petitioner on behalf of Sales without any compensation" (Division's brief, p. 14) an assertion clearly belied by the existence of the Management and Services charges.

Sixth, Ms. Janger analyzed the operating margins for petitioner and Sales Inc. to determine if there was a shifting of income from petitioner to Sales Inc. She found that petitioner:

> "earned an operating margin of 6.17 percent and Sales earned a margin of 3.49 percent in 1981. Since Sales' profit rate is lower than Times', it indicates that the overall outcome of the arrangement between the companies did not result in any shifting of income to Sales. If the arrangement had been entered into for the purpose of distorting income, the margins would most likely have resulted in Sales having the larger operating margin.

> "During 1982, the operating margins were 5.77 percent for the Times and 8.07 percent for Sales. Sales experienced growth while Times experienced some decline in 1982. However, this was reversed in 1983, when Times realized an operating profit of 15.39 percent and Sales earned 11.70 percent" (Ex. "133," p. 13).

Ms. Janger found that while the operating margins were not identical, this fact is not inconsistent with a bona fide cost-sharing agreement. "Benefits would be disproportionate if the profitability differed substantially over a significant period of time as a result of factors beyond the control of the parties" (Ex. "133," P. 14). She concluded that while there were differences in operating margins, they were not substantial and did not affect her conclusion that there was no shifting of income from petitioner to Sales Inc. through the intercorporate arrangements.

We agree with petitioner. The Division offers no analysis to controvert the conclusion drawn by petitioner, nor is there any reason in the record or offered by the Division as to why the comparison of operating margins for petitioner and Sales Inc. is not valid for the purposes for which offered, i.e., to test for shifting of income from petitioner to Sales Inc.

Seventh, Ms. Janger addressed the Division's assertion that the flow of funds from Sales, Inc. to petitioner, are loans which were not done at arm's length. Ms. Janger found that:

> "[i]n conducting this analysis, we concluded that the presence of a cumulative balance in the intercompany account between the Times and Sales should not have any effect on the operating income of either company. From an economic standpoint, the net flow of funds from Sales to the Times functioned as a constructive dividend rather than a loan. This is demonstrated by (i) the absence of any agreement to repay the balance, (ii) the fact that, except as necessary to meet direct operating costs, none of the funds transferred from [Sales to the Times] were paid back to Sales, (iii) the absence of interest payments on the cumulative balance, and (iv) Sales' inability to demand repayment or exert any control over the funds" (Ex. "133," p. 14).

Ms. Janger's conclusion is supported by petitioner's argument that:

> "it is well established that whether the transfer of funds from a subsidiary to a parent constitutes a loan or a dividend is determined by the intent of the parties [footnote omitted]. See, e.g., Crowley v. Commissioner of Internal Revenue, 962 F.2d 1077 (1st Cir. 1992); Jaques v. Commissioner of Internal Revenue, 935 F.2d 104 (6th Cir. 1991); Busch v. Commissioner of Internal Revenue, 728 F.2d 945 (7th Cir. 1984); Alterman Foods, Inc. v. United States, 611 F.2d 866 (Ct. Cl. 1979)" (Petitioner's reply brief, p. 83).

We agree. There is no indication anywhere in the record to indicate that Sales Inc. made loans

to petitioner or that the flow of funds from Sales Inc. to petitioner was intended to be a loan. The Division's assertion is founded solely on the fact that Sales Inc.'s balance sheet (Ex. "I" at Schedule L, line 18, accompanying Form 1120) shows a negative number on the line for "loans from stockholders." The Division offers no economic analysis to controvert Ms. Janger; it merely asserts that "Sales made millions of dollars in loans to petitioner without any compensation" (Division's brief, p. 14).

Finally, Ms. Janger compared the operating profits earned by petitioner and Sales Inc. to those of independent newspaper publishers with similar operations.

> "For purposes of this analysis we examined public companies primarily engaged in newspaper and newspaper related publishing. We sought to include companies that were primarily engaged in publishing one major metropolitan newspaper with some circulation throughout the U.S. However, significant variations of this ideal were examined as well. The results of this analysis can be found in Schedule 3. Schedule 4 sets forth a description of the newspaper companies studied on Schedule 3.
>
> "Operating margins were calculated for each company as for the Times and Sales. The operating margins of the companies examined ranged between -2.28 percent and 21.12 percent. The Times' and Sales' operating profit fall within this range and, therefore, they earn a profit within an arm's length range. Additionally, both the Times' and Sales' operating margins generally fell within one standard deviation of the average for the group. (Sales' 1981 operating margin failed to fall within this range by approximately 1%.)
>
> "Although the comparison of the Times and Sales to a broad range of newspaper companies verifies that their intercompany arrangement was at arm's length, these other newspapers generally have substantial operational and economic differences from the Times and Sales. However, one company seems to match the Times very closely regarding its regional nature, national acceptance, and market demographics: the Washington Post. Examining the Washington Post Company, the operating margin for 1981 through 1983 ranged from 8.36 percent to 13.71 percent. The Times' results are very similar since they range from 5.77 percent to 15.39 percent. This further verifies, in a striking manner, that the arrangement reflects an arm's length transaction and no distortion in income has occurred" (Ex. "133," pp. 15-16).

We agree with petitioner. Again, there is no analysis by the Division which controverts this conclusion, nor is there any reason in the record or offered by the Division as to why this comparison to other newspaper companies is not a valid third-party comparison for purposes of section 482.

In summary, petitioner has offered sufficient proof that the cost-sharing arrangement between it and Sales Inc., in accord with the principles of section 482, is arm's length and that

reporting on a separate basis results in a proper reflection of its New York franchise tax liability.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of The New York Times Company is granted; and

4. The notices of deficiency dated May 8, 1989 are cancelled and the refund claim dated July 17, 1990 is granted.

DATED: Troy, New York
August 10, 1995

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

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

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner

## APPENDIX A - THE NEW YORK TIMES COMPANY

| | 1981 | 1982 | 1983 | | | |
|---|---|---|---|---|---|---|
| | New York | Everywhere | New York | Everywhere | New York | Everywhere |
| (1) Average value of: | | | | | | |
| Real estate owned | $ 44,380,574.00 | $ 67,941,110.00 | $ 49,522,840.00 | $ 77,527,822.00 | $ 54,369,924.00 | $ 88,138,135.00 |
| Real estate rented | 5,740,688.00 | 11,387,912.00 | 6,281,760.00 | 12,412,024.00 | 6,810,808.00 | 12,416,248.00 |
| Inventories owned | 5,923,768.00 | 13,040,164.00 | 6,920,719.00 | 17,819,875.00 | 5,956,398.00 | 17,965,200.00 |
| Other tangible personal property owned | 74,064,673.00 | 156,797,677.00 | 88,740,298.00 | 191,075,775.00 | 101,027,868.00 | 230,504,018.00 |
| Total | $130,109,703.00 | $249,166,863.00 | $151,465,617.00 | $298,835,496.00 | $168,164,998.00 | $349,023,601.00 |
| % in New York State | 52.21789% | 50.68528% | 48.18155% | | | |
| (2) Receipts from: | | | | | | |
| Sales of tangible personal property shipped to points within N.Y.S. | $ 40,585,730.00 | | $ 49,828,879.00 | | $ 41,738,707.00 | |
| All sales of tangible personal property | | $ 72,088,331.00 | | $ 89,640,593.00 | | $ 80,074,416.00 |
| Services performed | 468,251,118.00 | 483,517,379.00 | 277,371,825.00 | 525,456,825.00 | 321,992,247.00 | 650,235,516.00 |
| Rentals of property | 335,080.00 | 335,080.00 | 312,912.00 | 312,912.00 | 362,245.00 | 362,247.00 |
| Royalties | 40,000.00 | 40,000.00 | 80,157.00 | 80,157.00 | 28,000.00 | 28,000.00 |
| Other business receipts | 2,239,521.00 | 2,573,241.00 | 1,884,748.00 | 1,969,023.00 | 2,089,490.00 | 2,519,348.00 |
| Total | $511,451,449.00 | $558,554,031.00 | $329,478,521.00 | $617,459,510.00 | $366,210,691.00 | $733,216,527.00 |
| % in New York State | 91.56705% | | 53.36034% | | 49.94578% | |

| | 1981 New York | 1981 Everywhere | 1982 New York | 1982 Everywhere | 1983 New York | 1983 Everywhere |
|---|---|---|---|---|---|---|
| (3) Wages, salaries and other compensation of employees, except general executive officers | $117,692,292.00 | $175,736,406.00 | $124,614,707.00 | $190,831,11 5.00 | $125,050,839.00 | $175,736,406.00 |
| % in New York State | 66.97092% | | 65.30104% | | 60.40425% | |
| Business Allocation Percentage[25] | 75.58073% | | 55.67675% | | 52.11934% | |

[25] The percentages for property, receipts and wages are totalled (with the receipts percentage added in twice) and then divided by four to calculate the business allocation percentage. For example, for 1981, 48.18155% plus 49.94578% plus 49.94578% plus 60.40425% equals 208.47736% divided by four equals 52.11934%.

APPENDIX B - THE NEW YORK TIMES SALES, INC.

| | 1981 | | 1982 | | 1983 | |
|---|---|---|---|---|---|---|
| | New York | Everywhere | New York | Everywhere | New York | Everywhere |
| (1) Average value of: | | | | | | |
| Real estate owned | | $ 780,334.00 | | $ 788,886.00 | | $ 627,756.00 |
| Real estate rented | $332,696.00 | 1,603,616.00 | $595,920.00 | 2,780,816.00 | | 3,276,104.00 |
| Inventories owned | | 113,807.00 | | 172,486.00 | | 265,772.00 |
| Other tangible personal property owned | 64,324.00 | 1,865,235.00 | 44,847.00 | 1 ,977,865.00 | $20,761.00 | 2,337,804.00 |
| Total | $397,020.00 | $ 4,362,992.00 | $640,767.00 | $ 5,720,053.00 | $20,761.00 | $ 6,507,436.00 |
| % in New York State | 9.09972% | | 11.20212% | | 0.31904% | |
| (2) Receipts from: | | | | | | |
| Services performed | $ 78,252.00 | $82,252,534.00 | $ 83,625.00 | $105,840,545.00 | None | $110,421,320.00 |
| % in New York State | .095136% | | .07901% | | 0% | |
| (3) Wages, salaries and other compensation of employees, except general executive officers | | $ 2,145,263.00 | $196,309.00 | $ 2,455,524.00 | None | $ 2,121,362.00 |
| % in New York State | 0% | | 7.99458% | | 0% | |
| Business Allocation Percentage | 2.75061%[26] | | 4.83868% | | 0.07976% | |

[26] The auditor changed this percentage to 2.32250%, which is the correct arithmetic: percentages for property, receipts (counted twice) and wages totalled and divided by four is 2.32250.