STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
TURBODYNE CORPORATION	:	DECISION DTA No. 812134
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Periods Ended December 31, 1973 through December 31, 1979 and October 31, 1984.	:	

Petitioner Turbodyne Corporation, c/o Cooper Industries, P.O. Box 4446, Houston, Texas 77210, filed an exception to the determination of the Administrative Law Judge issued on May 25, 1995. Petitioner appeared by Morrison & Foerster (Paul H. Frankel and Hollis L. Hyans, Esqs., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Robert Tompkins, Esq., of counsel).

Petitioner filed a brief on exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief. Oral argument was heard on January 11, 1996, 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.

ISSUES

I. Whether the Division of Taxation properly denied petitioner's request to file a combined report covering its parent and its brother/sister corporations because the statute of

limitations for assessment or refund had expired with respect to those other entities proposed to be combined with petitioner.[1]

II. Whether penalties imposed against petitioner based on its failure to timely report Federal audit changes, as required per Tax Law § 211(3), should be abated.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Combined Filing

During the years in issue, petitioner, Turbodyne Corporation ("Turbodyne"), was a wholly-owned subsidiary of Edison International, Inc. ("Edison"). Edison also owned 100% of the stock of Campbell Chain Company ("Campbell") and Worthington Compressors, Inc. ("Worthington").

Effective November 1, 1984, petitioner was sold by Edison.

Turbodyne, Edison, Campbell and Worthington were each subject to New York State corporation franchise tax, and filed separate New York State corporation franchise tax reports ("State reports"). More specifically, on October 15, 1985, petitioner filed a State report for the short period spanning January 1, 1984 through October 31, 1984. Although petitioner was a calendar year taxpayer and maintained its books and records on a calendar year basis (as did Edison, Campbell and Worthington), both its Federal pro forma income tax return included in the Federal consolidated return of petitioner and its affiliates, and its State report, included income from its operations only through the October 31, 1984 date of the sale of petitioner's

[1]The parties have agreed that, in the event petitioner is permitted to file a combined report covering its parent and its brother/sister corporations, the Division of Taxation will have a period of one year from the date of final determination granting such permission in order to conduct an audit of the respective State reports included in the combined report (other than to redetermine whether petitioner may file a combined report). Petitioner, in turn, will have an opportunity to contest any proposed adjustments which may result from such audit as prescribed by the Tax Law.

stock by Edison. Petitioner was required to file a separate State report for the remainder of its taxable year, i.e., November 1, 1984 through December 31, 1984. Also on October 15, 1985, Edison, Campbell and Worthington filed their respective State reports for the 1984 calendar year.

In May 1988, the Division of Taxation ("Division") commenced a field audit of petitioner's State report for the short period ended October 31, 1984. During the course of the audit, petitioner requested that it be permitted to file a combined franchise tax report ("combined report") including Edison, Campbell and Worthington.[2]

On January 31, 1990, a Notice of Deficiency was issued to petitioner asserting additional tax due for the short period ended October 31, 1984 in the amount of $67,818.00, plus interest. In addition, the Division did not permit petitioner to file a combined report with Edison, Campbell and Worthington.

Petitioner timely filed a protest to the Notice of Deficiency and requested that a conciliation conference be held. Petitioner asserted that its State report for the period ended October 31, 1984 should be filed on a combined basis covering Edison, Campbell and Worthington in order to properly reflect its income.

On April 27, 1990, while the statute of limitations for refunds was still open for petitioner with respect to its short period ended October 31, 1984, a combined report was filed, including petitioner, Edison, Campbell, Worthington and McGraw-Edison International Sales Corporation ("McGraw-Edison") and a refund was requested.[3]

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[2]It would appear that petitioner's request during the audit for combined filing was an oral request. In this regard, the Division's brief notes that petitioner's first formal request for combined filing was not made until after the Division's Notice of Deficiency had been issued and after the Tax Appeals Tribunal had issued its decision in Matter of Autotote, Ltd. (April 12, 1990). However, the Division does not dispute that, upon audit, petitioner requested permission to file a combined report, and does not argue that petitioner's request was not timely in light of Autotote.

[3]Edison had previously filed an amended State report for 1984, as a result of State audit adjustments, together with McGraw-Edison, a wholly-owned domestic international sales corporation.

A conciliation conference was held on November 19, 1991 and thereafter, on May 7, 1993, a Conciliation Order was issued sustaining the Division's Notice of Deficiency. As sustained, the Division's position was (i) that the statute of limitations barred combined filing (i.e., corporations whose tax years were closed could not be included in the combined group), and (ii) that combined filing was barred because not all members of the proposed combined group used the same accounting period.

On July 27, 1993, petitioner timely filed a petition contesting the Conciliation Order and objecting to the Division's denial of a claimed $1,043,027.00 refund. This refund amount was determined via a formula whereunder petitioner multiplied the total refund which would have been due if the statute of limitations had been open for Edison, Campbell, Worthington and McGraw-Edison by a fraction, the numerator of which was petitioner's 1984 corporation franchise tax liability as reported on its separate State report (plus the additional tax set forth in the Notice of Deficiency for that period) and the denominator of which was the total corporation franchise tax liability, on a separate basis, of all members of the proposed combined group. This calculation may be set out as follows:

$$\frac{\text{petitioner's separate report tax liability}}{\text{total tax liability, on a separate basis, of all group members}} \times \text{total refund for group}$$

- OR -

$$\frac{\$1,102,455.00}{\$1,202,793.00} \times \$1,133,725.00 = \$1,043,027.00$$ [4]

The Division does not contest that petitioner, together with Edison, Campbell, Worthington and McGraw-Edison, meet the stock ownership, unitary business and distortion requirements for combination which are set forth in corporation franchise tax regulations sections 20 NYCRR 6-2.1, 6-2.2 and 6-2.3. Furthermore, the Division does not assert that petitioner's request to file a combined report with its affiliates is untimely in that it was made more than 30 days after the close of petitioner's taxable year ended October 31, 1984. Finally,

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[4] The ratio used to determine the portion of the total refund attributable to petitioner was rounded to 92%.

the Division concedes that the statute of limitations for assessment or refund with respect to petitioner remains open. In contrast, petitioner acknowledges that the statute of limitations for assessment or refund has expired with respect to Edison, Campbell and Worthington.

Penalties

On January 15, 1988, the Internal Revenue Service ("IRS") finalized Federal audit changes pertaining to petitioner for the years 1973 through 1976. Thereafter, in April 1988, the IRS finalized Federal audit changes pertaining to petitioner for the years 1977 through September 30, 1979.

On or about March 9, 1988, the Division contacted petitioner and scheduled an audit appointment for May 9, 1988 covering these Federal audit change years (it would appear that such audit was a part of the audit covering petitioner's taxable period ended October 31, 1984 [see, above]). Although petitioner was aware of the statutory requirement to report the Federal audit changes to the Division within 90 days of finalization, petitioner did not formally do so.

On January 31, 1990, notices of deficiency for additional tax, interest and penalty totalling $420,177.00 were issued to petitioner as the result of Federal audit changes for the taxable years 1973, 1977, 1978 and for the taxable year ended September 30, 1979. Petitioner timely filed a protest against these notices of deficiency seeking a waiver of penalties and requesting that a conciliation conference be held. On May 7, 1993, a Conciliation Order was issued sustaining the imposition of penalties.

Petitioner's main argument against the imposition of penalties centers on the claim that at the time the Federal audit changes were finalized, petitioner knew that the Division's audit covering the same years was imminent and thus determined that it was unnecessary to formally file a report of the Federal changes.

OPINION

Every corporation is a separate taxable entity and shall file its own report (Tax Law § 211[1]; 20 NYCRR 6-2.1[a]). However, the Division, in its discretion, may require or permit corporate taxpayers to file combined reports in order to properly reflect tax liability under Article 9-A of the Tax Law (Tax Law § 211[4]; 20 NYCRR 6-2.1[a]). The Division's regulations amplify the statute by providing that the Division may require or permit combined reporting of two corporations where three conditions are met: (1) an 80% 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). Each corporation in the combined report must compute and show the tax which would have been required to be shown if filed on a separate basis (20 NYCRR 6-2.1[b]). The term report "means a report or return of tax, but does not include a declaration of estimated tax. (See Part 6 of this Title - Reports)" (20 NYCRR 1-2.10, emphasis added; see also, Tax Law § 1080[b][1]). Part 6-3.2 of the Division's regulations provides that:

> "[i]n all cases where a combined report is required or permitted . . . a combined franchise tax report must be submitted on form CT-3A. The corporation responsible for paying the combined tax must file form CT-3A -- Rider with its forms CT-3 and CT-3A. In addition, a separate franchise tax report must be filed for each corporation in the combined group on form CT-3. Form CT-3 need not repeat any information which is contained in the combined report on form CT-3A" (20 NYCRR 6-3.2[a]).

Tax Law § 1083(a) provides a three-year statute of limitations on the assessment of additional tax by the Division, with exceptions not relevant to this case. The three-year period is measured from the time "the return was filed." The period for assessment may be extended by agreement between the taxpayer and the Division (Tax Law § 1083[c][2]). There is no language in the section which specifically addresses the filing of a combined report for a group of affiliated corporations.

Tax Law § 1087(a) provides that a claim for refund or credit of an overpayment of taxes must be filed "within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed, within two years from the time the tax was paid." The section limits the amount of the refund or credit

to the amount of the tax paid within the period of limitation, i.e., two or three years. The period may be extended by agreement between the taxpayer and the Division (Tax Law § 1087[b]). There is no language in the section which specifically addresses the filing of a combined report for a group of affiliated corporations.

In the instant case, the parties have stipulated that the statute of limitations has been extended for petitioner but has expired for petitioner's parent, Edison International, Inc., and petitioner's two sister corporations, Campbell Chain Company and Worthington Compressors, each of which were subject to New York taxes for the period at issue and each of which filed separate franchise tax reports for the period.

The Administrative Law Judge concluded that in order for a combined report to be required or permitted, the statute of limitations on assessments (section 1083[a]) and refunds (section 1087[a]) must be open for all the corporations in the combined group for the years at issue.

> "First, both the Division and taxpayers should be able to rely on the finality provided by expiration of the statute of limitations. . . . Stated simply, a taxpayer ought to be able to rely upon the proposition that its results or those of its affiliates will not be disturbed or changed by after-the-fact inclusion of closed-year entities. It is equally unfair for the Division to be able to revive and include a 'dead-year' corporation as the springboard from which to generate an assessment as it is for a taxpayer to revive and use a 'dead-year' corporation to generate a refund" (Determination, conclusion of law "D").

The Administrative Law Judge found support for his conclusion in the Division's regulations, specifically 20 NYCRR 8-1.3(a), which provides as follows:

> "Where the tax is computed on the basis of a combined report, the [Commissioner of Taxation] may assess the entire amount of the tax and all additional taxes computed on the basis of such report against any one or more of the taxpayers covered by the combined report, in such proportions as [he] determines, but every such taxpayer is liable for the entire amount" (emphasis added).

The Administrative Law Judge concluded that this language leads directly to a conclusion that all members of the combined group must have open tax years.

> "That is, the regulation plainly states that the Division can assess any of the taxpayers in the combined group. In turn, it is clear that the statute of limitations on assessment must be open in order for the

> Division to assess liability. The regulation does not limit this right to assess any combined group taxpayer by stating that "the Commissioner may assess any combined group taxpayer unless such an assessment is precluded by the statute of limitations on assessment." Rather, the regulation simply provides that all taxpayers covered by the combined report are liable for tax and may be assessed. It follows then that all of such group member taxpayers must have open years in order to be included in the group" (Determination, conclusion of law "E").

We deal first with petitioner's argument on exception that the Administrative Law Judge erroneously mixes two separate and distinct concepts -- the statutory and regulatory prerequisites for filing on the basis of a combined report, and the time limits for a taxpayer to obtain a refund or for the Division to assess additional tax.

> "There is no basis under the law or regulations to support the conclusion [reached by the Administrative Law Judge] that a statute of limitations for assessment or refund with respect to a separate corporation is relevant in determining whether a taxpayer may file as part of a combined group with that corporation.
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> "A combined report is a computational method used to compute the respective amounts of entire net income attributable to New York State of each taxpayer that files as part of a combined report.
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> " . . . Contrary to the Division's assertion, a combined group is not a taxpayer or otherwise a separate legal entity and a combined report is not itself a return for the combined group. The purpose of a combined report is to accurately reflect the income of each taxpayer which files as part of the combined group" (Petitioner's brief, p. 6).

Petitioner asserts that 20 NYCRR 8.1-3(a), relied upon by the Administrative Law Judge:

> "does not address, either directly or by implication, whether all corporations must all have years open for assessment or refund in order to be included in a combined report with an open year taxpayer such as Petitioner. The regulation merely authorizes the Division to assess all of the tax on a combined basis against 'any one or more of the taxpayers covered by the combined report.' Contrary to the ALJ's view, the regulation demonstrates that the expiration of the statute of limitations for assessment with respect to a particular taxpayer within the combined group merely precludes the Division from assessing tax against that taxpayer. It follows that the Division may continue to assess all of the tax against other combined taxpayers whose years remain open for assessment even if the assessment arises from the combination of an entity whose year is closed for assessment.
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> "Similarly, the expiration of a taxpayer's limitations period for claiming a credit or refund should bar that taxpayer -- and only that taxpayer -- from obtaining a credit or refund. It should not, however, affect the ability of an open year taxpayer such as Petitioner to receive its share of the total refund for the combined group. The ALJ's interpretation represents a

> misreading of an otherwise clear regulatory provision that merely sets forth rules for assessing taxpayers, not for determining whether a taxpayer may properly file a combined report" (Petitioner's brief, p. 13).

Petitioner argues that the formula it used "in ascertaining its portion of the total refund of the 'combined group' . . . insures that only the portion attributable to an open year taxpayer is refunded" (Petitioner's brief, p. 14).

We affirm the determination of the Administrative Law Judge.

Petitioner is correct when it states that the purpose of combined reporting is proper reflection of income (Matter of Sears, Roebuck & Co., Tax Appeals Tribunal, April 28, 1994; Matter of USV Pharm. Corp., Tax Appeals Tribunal, July 16, 1992).

Petitioner is also correct that combined reporting is a computational method. "Combined reporting is the tax accounting practice whereby separate corporations are effectively treated as one entity for state franchise tax or income tax purposes" (Report on Combined Reporting for New York Corporate Franchise Tax Purposes by the Committee on New York State Tax Matters of the Tax Section of the New York State Bar Association, October 14, 1988).

However, petitioner errs when it asserts that combined reporting is solely a computational method and that "a combined group is not a taxpayer or otherwise a separate legal entity and a combined report is not itself a return for the combined group" (Petitioner's brief, p. 6).

We refer again to the Report of the Tax Section of the State Bar:

> "[o]nce the income or capital of the combined group has been determined, a portion is apportioned or allocated to the taxing state according to factors relating to the combined group's presence within the state. . . . The objective of combined reporting is to determine the portion of the group's combined income that is attributable to activities in the taxing state of those entities that are taxable in that state; each taxable entity is then jointly and severally liable for the combined tax due" (Report on Combined Reporting for New York Corporate Franchise Tax Purposes, supra).

As the Division's regulations make clear, the CT-3A Combined Franchise Tax Report is the "return" for the group which, as do all returns, reflects the computation of the tax due from the combined group. It is a return for purposes of the statute of limitations in sections 1083(a) and 1087(a) (20 NYCRR 1-2.10) which must be timely filed to allow each corporation in the group to claim the refund or credit where there is an overpayment and, conversely, makes each

jointly and severally liable for any assessment issued by the Division (20 NYCRR 8-1.3[a]). To allow combined reporting on the basis asserted by petitioner, i.e., where only one member of the group is open, is not only inconsistent with the statutory and regulatory framework, but carried to its logical end, invites a myriad of contentious issues in varying contexts. For example, should the open year taxpayer be entitled to collect the entire refund (or be liable for the full assessment) where the period of limitations to apply for refund (or to assess additional tax) has closed for all the other members of the group?

Petitioner's "proportionate" solution, while it has the gloss of "fairness" by asking only for petitioner's "proportionate share" of the refund that would otherwise flow to the entire group (while limiting the Division to collecting only petitioner's proportionate share of any asserted liability), not only has no statutory or regulatory basis, but serves to mask the inherent distortion which results when petitioner's tax liability is calculated on a combined basis with closed year taxpayers. In this case, for example, each of the corporations has filed on a separate basis. To now allow filing on a combined basis is to include for a second time items of income and deduction which have already been the subject of the separate reports of the closed year corporations, the results of which cannot be changed by either the taxpayer or the Division.

We conclude that a combined report is a return for purposes of sections 1083(a) and 1087(a) and that the periods of limitation prescribed in such sections must be open for all members of the combined group.

We deal next with petitioner's assertion, relying on Lewis v. Reynolds (284 US 281) and National Cash Register Co. v. Joseph (299 NY 200), that "[i]n the alternative, fairness requires that petitioner be entitled to set off against the Division's assessment for the year in issue the amount of its overpayment" (Petitioner's brief, p. 15).

We cannot agree.[5] The doctrine of equitable recoupment allows a taxpayer against whom a deficiency is asserted to offset against that deficiency overpayments which are time barred for claiming a refund and (1) involve the same type of tax as the deficiency; (2) were paid during the period that comprises the deficiency; and (3) involve the same transaction as is the subject of the deficiency (National Cash Register Co. v. Joseph, supra, 203). This doctrine, however, is not available because petitioner, in its own right, has no overpayment of tax for the same period as the deficiency entails. The overpayment petitioner seeks to apply to its deficiency only comes into being by the filing of a combined report with its affiliates -- a proposition we have steadfastly rejected.

We deal finally with petitioner's assertion that it "has demonstrated reasonable cause for its failure to timely report final changes in Federal Taxable Income" (Petitioner's brief, p. 17). Petitioner asserts that it reasonably believed:

> "it would be unnecessary to formally file a report of federal audit changes since at the time the federal determinations became final an audit by the Division was imminent. The Tribunal's decision in Matter of Paramount Pictures [Tax Appeals Tribunal, March 14, 1991] is not binding precedent due to the significant differences between the facts in that case and those herein. In Paramount, federal changes finalized in September 1984 were not reported to the Division until July 1986 (22 months) and federal changes finalized in September 1985 were not reported until September 1986 (12 months). Here, Petitioner reported the federal audit changes, during the course of the Division's pending audit. Petitioner's delay in filing 'reports' of federal audit changes was properly attributable to reasonable cause and not to willful neglect. That Petitioner was 'aware' of its filing obligations and made a 'conscious decision' not to timely file does not detract from its position that, in view of the imminent audit by the Division -- and particularly in view of its exemplary prior filing record in New York -- Petitioner had reasonable cause for the delay in filing reports of the federal audit changes" (Petitioner's brief, p. 18).

We cannot agree. In the determination below, the Administrative Law Judge, relying on our decision in Matter of Paramount Pictures Corp. (supra), held that petitioner had not established reasonable cause for failure to timely report Federal audit changes due to its

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[5]This argument was raised for the first time in petitioner's brief in support of its exception. The Division contends that petitioner should have raised this in its exception papers and that petitioner should be estopped from raising this issue this late in the proceedings. However, because this is a new legal issue rather than a factual issue and the Division has not been prejudiced as it had the opportunity to respond and did so respond, we will entertain petitioner's argument (see, Matter of Chuckrow, Tax Appeals Tribunal, July 1, 1993).

conscious decision to disregard such duty. On exception, petitioner makes the same arguments as made before the Administrative Law Judge. The Administrative Law Judge completely and adequately addressed this issue and we affirm for the reasons stated therein.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Turbodyne Corporation is denied;

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

3. The petition of Turbodyne Corporation is denied; and

4. The notices of deficiency dated January 31, 1990 are sustained and petitioner's request for refund is denied.

DATED: Troy, New York
July 3, 1996

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

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

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