STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
PANAVISION, INC.	:	DECISION DTA NO. 816660
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1991.	:	

The Division of Taxation and petitioner Panavision, Inc., c/o Ernst & Young, LLP, 787 7th Avenue, Room 1729, New York, New York 10019, each filed an exception to the determination of the Administrative Law Judge issued on July 13, 2000. Petitioner appeared by McDermott, Will & Emery (Arthur R. Rosen, Esq., of counsel) and Ernst & Young, LLP (Russell Levitt, Esq., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel).

Petitioner filed a brief in support of its exception, the Division of Taxation filed a brief in support of its exception and in opposition to petitioner's exception and petitioner filed a brief in reply and in opposition to the Division of Taxation's exception. The Division of Taxation filed a reply brief. Oral argument, at the request of both parties, was heard on December 12, 2001 in New York, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether the statute of limitations prohibits the Division of Taxation from assessing petitioner on a separate-company basis.

II. Whether the Division of Taxation properly determined that petitioner should file its New York State corporation franchise tax reports on a separate basis.

III. Whether petitioner has established that it acted in good faith and the existence of reasonable cause for the abatement of penalties.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge and make an additional finding of fact. The Administrative Law Judge's findings of fact and the additional finding of fact are set forth below.

During 1991, Panavision, Inc. ("petitioner" or "Panavision") operated as a designer, manufacturer and distributor of film camera systems for the motion picture and television industries. Panavision handled the leasing of its systems to both end-user customers and to related[1] and unrelated distributors, who in turn rented them to end-users, generally represented by producers of entertainment products. Unrelated distributors received training and support to insure that Panavision's customers received the same high level of service that they would receive from the company itself. Additionally, petitioner leased movie camera lines other than its own.

The camera systems were used in feature films, commercials, episodic television, movies of the week and other activities. The company maintained an inventory of non-Panavision

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[1] There was no evidence introduced that a related distributor referred to any of the companies proposed for combination.

cameras in its product offerings in addition to its own brand, which gave Panavision an edge over its competitors, which were few. One of the lenses manufactured by Panavision was considered state of the art. Its manufacturing facility was located in Tarzana, California, and its primary domestic marketing target was Los Angeles, California. There were also shops located in Hollywood, California and Orlando, Florida. Panavision maintained an international division run by Panavision Europe, which was headquartered in England, and made up of several other companies. Panavision's sales representatives in all of the varied locations worked closely with its customers by developing close relationships with cinematographers, directors and producers. During the first five months of 1991, Panavision earned revenue in the amount of $26.7 million and employed about 400 people, including some 30 engineers, draftsmen and machinists in the design and development process. During the period in question, 1991, petitioner was the wholly-owned subsidiary of Lee International Acquisitions, whose stock was owned 100% by Lee Panavision International, Inc. ("LPI"),[2] which became Lee International, Inc. after June 1, 1991.

LPI, Panavision, Lee Lighting America, Ltd., Lee Colortran Holdings, Inc., Lee Colortran, Inc., Lee America West, Ltd., and Lee International Acquisitions, Inc. filed a New York State Combined Franchise Tax Return (Form CT-3-A) for the tax year ended December 31, 1991, on or about December 15, 1992. All the entities were calendar year corporations. At the time of filing, LPI and its subsidiaries attached to the combined return a request for them to be allowed

[2] The testimony provided at the hearing and the documents conflict as to whether LPI was in direct ownership of Panavision or whether Lee International Acquisitions was an intermediary holding company between LPI and Panavision. Of the number of times this issue arises, more frequently the position is taken that Lee International Acquisitions was in direct ownership of Panavision's stock, with LPI holding the stock of Lee International Acquisitions. For purposes of discussion, this will be assumed to have been the case.

to file on a combined basis. The business and activities of the corporations were outlined in the attachment. The combined filing documents indicate that Lee Colortran Holdings and Lee Lighting own 100% of the stock of Lee Colortran and Lee America West, respectively. LPI owns 100% of the stock of Lee International Acquisitions, which in turn holds the shares of Lee Colortran Holdings and Panavision. Although the attachment describes the proposed group of companies as having operated as a unitary business since December 16, 1988, prior to tax year 1991, petitioner had not filed, or requested to file, on a combined basis with LPI or its affiliates.

The Combined Franchise Tax Return, Form CT-3A, shows separate and combined alternative business income for allocation for each of the seven companies as follows:

LPI	$ -43,946,209
Lee Lighting America	-1,597,057
Lee Colortran Holdings	121,538
Lee Colortran	-4,056,781
Lee America West	122,606
Lee International Acquisitions	-2,057,244
Panavision	58,455,202

In addition, a New York State capital loss carry forward in the amount of $2,400,000.00 from LPI was also a factor in the computation of combined alternative business income, which ultimately formed the basis for the corporate franchise tax computed on combination.

Lee Colortran and Lee Lighting America were involved in the manufacture and distribution of lighting equipment for motion picture, television, theater and studio businesses. A press release described Lee Lighting America as a London-based company which acted as the

largest supplier in Europe of rental lighting equipment to the motion picture and television industries. Panavision and Lee Lighting America shared rental space in Orlando, Florida, which was leased by Lee Lighting America. There Lee Lighting America sold lighting equipment and Panavision leased camera equipment. Panavision paid Lee Lighting America for a proportion of the lease, but the terms were not made a part of the record. Each employed seven or eight people in that location. Panavision handled the administration of accounts payable for the Orlando store for both companies, without a charge back to Lee Lighting America.

Lee America West, although still incorporated as a legal entity during 1991, was inactive during the audit period.

Commencing in 1996, the Division of Taxation ("Division") conducted a field audit of petitioner for the period January 1, 1991 through December 31, 1991 ("the audit period"). Petitioner executed several consents extending the statute of limitations to assess the corporation franchise tax allegedly due. The latest extended the statute of limitations to assess corporation franchise tax for the audit period until April 30, 1998. As a result of the audit, the Division issued to petitioner a Notice of Deficiency dated April 20, 1998, asserting a deficiency of New York State corporation franchise tax (which would have been associated with the filing of Form CT-3, a separate corporation franchise tax return) in the amount of $260,178.00, plus penalties and interest in the amounts of $27,318.85 and $156,755.63, respectively, and franchise taxes which would have been due pursuant to the filing of Form CT-3M/4M in the amount of $58,461.00, plus penalties and interest in the amounts of $4,038.30 and $23,173.04, respectively, for a total assessment of $509,923.82. The basis for the notice was the assertion by the Division that Panavision should have filed its 1991 New York State franchise report on a separate basis.

There has been no assertion or evidence that any of the other six entities seeking combination with Panavision was issued an assessment.

On or about July 17, 1998, petitioner, by its representatives, filed a timely petition before the Division of Tax Appeals, protesting the notice of deficiency. Petitioner asserted it should be allowed to file on a combined basis with LPI, that all penalties should be abated, and all costs and legal fees incurred be reimbursed pursuant to Tax Law § 3030.[3]

The Division filed its answer on or about October 8, 1998, which affirmed common ownership among the proposed combined entities, but denied the existence of a unitary relationship and the existence of distortion if the companies filed on a separate reporting basis.

LPI and its many subsidiaries ("the Lee group")[4] have operated as a group since December 16, 1988, when Lee International, Ltd., the parent company at that time, acquired its subsidiaries. Lee International, Ltd. incurred approximately $340 million in debt in late 1987 to take Lee International, PLC, a company then trading on the London Stock Exchange, to private company status by buying back its publicly held shares, to purchase Panavision (for approximately $110 million) and restructure its existing debt. After Lee International, PLC went private, it was renamed Lee International, Ltd. Lee International, Ltd. became a subsidiary of the parent holding company, LPI, incorporated in Delaware in July 1988.

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[3]Petitioner requested costs pursuant to Tax Law § 3030 in its petition. The Administrative Law Judge correctly deemed such motion premature since a judgment for reasonable litigation costs can only be made after an exhaustion of administrative remedies (Tax Law § 3030[b]) and a determination of the prevailing party (Tax Law § 3030[c][5][C]).

[4] Additional subsidiaries were set forth in a corporate chart depicting the entire Lee group, and submitted into evidence as an attachment to the expert's Transfer Pricing Report. It encompasses approximately 30 additional corporations, some inactive, that were not a part of the proposed combined filing.

In order to induce loans and cash advances, the lenders, the primary one being Citicorp Industrial Credit, Inc. ("Citicorp"), required the Lee group to execute a pledge agreement whereby Lee America West, Lee Colortran, Lee Colortran Holdings, Lee Lighting America, Panavision and Lee International Acquisitions pledged their stock as collateral for the debt. If any of the companies whose stock was pledged as collateral paid dividends, to the extent the dividends were not prohibited by the original credit agreement, the dividends became a part of the pledged collateral. The original credit agreement was not made a part of the record.

By early 1988, the Lee group was in default of the loan, having insufficient cash to make the interest payments. Citicorp, the largest lender, approached the New York fund management group Warburg Pincus Capital Group ("Warburg Pincus") to participate in operating and restructuring the company. Warburg Pincus stepped in and made an investment of $60 million, proceeded to take over the group and hired a new management team, led by William C. Scott. Warburg Pincus, having been previously acquainted with Mr. Scott's background, gave Mr. Scott complete authority to act on his behalf as a 90% shareholder. By 1991, Mr. Scott owned the other 10% of LPI. At the time Mr. Scott joined the Lee group, he was given the task of cleaning up the company that was headquartered in London and improving on the operations of Panavision, which he considered the "gem of the group." The ultimate goal was to eventually take Panavision public, which actually took place in 1996.

William C. Scott was appointed chairman, president and CEO of LPI and Lee International Acquisitions, the two holding companies that directly or indirectly owned Panavision and the other five companies involved in the combination which is the subject of this matter. He became affiliated with LPI in December 1988 and remained with the group until his resignation as CEO

and president of LPI in January 1999. Prior to his affiliation with LPI he was chief operating officer and president of a public company known as Western Pacific Industries, where he assisted the CEO in making acquisitions of other companies and then being responsible for their management.

Mr. Scott's responsibilities as CEO of LPI included management overview of the operations of virtually the entire Lee group. He provided management direction to Panavision through John Farrand; he was responsible for the appointment of all officers and directors at Panavision and LPI; he approved all capital expenditures at Lee and Panavision over $20,000.00; he approved hiring and firing of employees earning over $40,000.00; he would comment upon work policies at Panavision that may have needed revision; and he was compensated only by LPI. While Mr. Scott was at LPI for 1991, he frequently spoke with and visited people at Panavision. However, since he lived in New York, was based in London, and Panavision was located in California, he left the running of Panavision to John Farrand. He described his primary role with LPI as one responsible for rationalizing the assets. He was to close or sell off businesses that were not desirable to keep, and make the most of ones that were properly managed.

With respect to Mr. Scott's role in the negotiations with Citicorp and the bank group, he was the key person from the end of 1988 through the 1991 reorganization. During the restructuring in June 1991, he was the principal initiator of the LPI side of the negotiations.

In 1991, Mr. Scott had dealings with a company referred to as General Camera ("GC"). General Camera acted as an agent for Panavision for approximately 25 years. Panavision would ship cameras to GC, which would in turn rent the cameras to another user. GC would pay

Panavision 60% of the revenues and keep 40% for itself. GC fell behind in its 60% payments and owed Panavision $1.5 to $2 million at one point. On behalf of Panavision Mr. Scott had discussions with GC concerning payment terms and UCC filings for guarantees. He was employed by LPI at this time and was not paid by Panavision for such negotiations.

Joseph McGonigle was the corporate controller of LPI and spent approximately one-half of his professional time on preparing financial reports and statutory filings. Other time was spent on Panavision matters in both the United States and Europe. Such matters were not detailed by petitioner in the record. As of May 1989, Mr. McGonigle served as secretary of Panavision. There is no mention of how long he held this position or what the office entailed.

Arthur Dignam, Chief Financial Officer of LPI, spent some of his time on the European branch of Panavision and a significant amount of time working with Mr. Scott and the banking group handling the debt. As of May 1989, he served as vice president of Panavision. There is no mention how long he held this position or what the office entailed.

Ronald Buchner was an analyst for LPI who spent a portion of his professional time on regulatory compliance. Similarly, Gary Goldner handled some regulatory compliance. Mr. Goldner also spent a portion of his professional time on Panavision matters in both the United States and Europe. These duties were not further detailed in the record. Buchner and Goldner did not report to Mr. Scott, but rather to Arthur Dignam and Joseph McGonigle.

Jeffrey Marcketta was LPI's vice president of corporate development. In 1991, he was actively involved with Mr. Scott in restructuring the Lee group businesses and the debt.

LPI did not receive compensation for any management services it provided Panavision or any of the other subsidiaries.

John Farrand, who had been with Panavision since 1985, is the current president and CEO of Panavision. In 1991, prior to the Lee group reorganization, he ran Panavision for Mr. Scott earning approximately $300,000.00. His responsibilities essentially encompassed running the day-to-day business of Panavision. There was also a management team at Panavision, consisting of Panavision employees compensated by petitioner. The key personnel were John Farrand, Phil Radian, Bob Harvey and Ian Neil. During 1991, Phil Radian was the head of the marketing department, reporting to John Farrand, and Robert Leeper was the chief financial officer of Panavision. No further information concerning these executives was established by the record. The management team was made up of an additional 10 to 20 individuals, whose names and duties were not provided.

Lee International, Ltd. was a holding company, and it was parent to some significant Panavision operations such as Panavision Europe, Panavision France and Panavision Italy. Panavision Europe, Ltd. held the stock of Lee Filters, Ltd., Panavision France, S.A., K.N.J., Ltd., Joe Dunion Cameras (Ireland), Ltd., and Panavision U.S.S.R., Ltd., all of which were operating companies. The president of Lee Filters reported to Mr. Scott. Panavision France (other than for a brief period), K.N.J., Ltd., Joe Dunion Cameras, and Panavision U.S.S.R., Ltd., reported up through the president of Panavision Europe to John Farrand. Mr. Scott would advise Mr. Farrand concerning these operations.

LPI performed a sweep of cash from Panavision, Lee Colortran and Lee Lighting America in an attempt to meet payments on its large corporate debt. As to Panavision's cash account, the sweep took place on a daily basis in 1991(and earlier years) whenever LPI needed the funds, unless the laws of a foreign country prevented the sweep. Mr. Scott, however, was unsure

whether the sweep was performed daily, and was unfamiliar with its actual mechanics. He could not say with certainty if the transaction was recorded as a loan, though he believed it may have been. He was certain, however, that LPI got all the cash possible out of Panavision, and knew that LPI was making debt payments with the funds. LPI did not compensate Panavision in any way for the use of this money. There was no written evidence of the debt. Petitioner had no right to demand repayment of the cash swept, and Panavision's expectation of repayment was expressed in very vague terms on the record.

Between 1986 and 1991 Panavision was a very profitable company, with a great deal of excess cash, which it managed on its own before the sweep program was set up. Panavision did not benefit from the 1987 acquisition by Lee International. Regarding the cash sweeps, from a cash management perspective, Panavision derived some benefit only to the extent that its cash was being used to pay off debt of a related company, since Panavision had no debt of its own.

Christopher Phillips was employed by Panavision International between 1985 and early 1999. He assumed the position of controller in 1989, and held that position during the audit period. He remained with Panavision until 1999. Mr. Phillips was compensated by Panavision and, in 1991, reported directly to Robert Leeper, Panavision's CFO.

Mr. Phillips was in control of the treasury operations in the United States and responsible for making sure there were systems in place that would allow for the mechanical sweep of cash to LPI, or what he referred to as the Lee intergroup. A zero balance account was set up to handle the mechanics of the transfers of funds. The cash sweeps commenced sometime in 1989, and Panavision had no authority to limit the amount of cash transferred to LPI, because as owner, LPI was in charge. Panavision understood that it was part of an overall group that had incurred a

large bank debt, repayment of which would be handled in conjunction with the anticipated reorganization of the Lee group.

Management systems that were put in place required the accounting group to go on a new reporting system, and Mr. Phillips was responsible for making sure all divisional operations in the United States complied with that reporting accurately. Concerning cost controls, Mr. Phillips was required to have his disbursements preauthorized by Mr. McGonigle on a daily basis. In addition, a reporting chain was required to be maintained by Panavision to create a replacement or addition to staff, and all such changes had to be authorized by LPI.

Interest was paid on the original Lee group debt until the end of 1988 when another default occurred. Defaults on the debt continued until the companies underwent reorganization in June 1991. During this time LPI was not considered creditworthy, since its bond rating would be considered nonexistent, and the company had no ability to raise capital other than on an equity basis.

THE ERNST & YOUNG REPORT

Petitioner submitted into evidence a report entitled "Lee Panavision International, Transfer Pricing Study for the Period January 1, 1991 to May 31, 1991" ("the report"), prepared by the accounting firm of Ernst & Young, LLP, explained through the testimony of Elizabeth Galvin, a senior manager in the economic consulting practice of the firm. Ms. Galvin was qualified as an expert in transfer pricing, specializing in state and local transfers and international transfer pricing. The report, prepared by Ms. Galvin for Panavision, examined two intercompany transactions between LPI and Panavision for the first five months of 1991, before the June 1,

1991 restructuring of the companies. Ms. Galvin analyzed the arm's length character of the following transactions:

1) The management services provided by LPI to Panavision for the five-month period; and

2) The transfer or advance of cash from Panavision to LPI over the same period, and the interest that may have been owed to Panavision for such transfers.

The principal objective of the report was to assist Panavision's management in determining the arm's length nature of intercompany transactions between LPI and other New York taxpayers within the Lee group for 1991, in compliance with Internal Revenue Code ("IRC") transfer pricing regulations set forth in IRC § 482.

Regarding the management services, Ms. Galvin's conclusion was that Panavision should have compensated LPI for the services, and in the absence of doing so, such services were not provided at arm's length. Concerning the transfer of cash from Panavision to LPI, she concluded such transactions were not arm's length because interest was not paid by LPI to Panavision. In addition, there were other transactions that may have resulted in distortion, such as loan guaranty agreements, cash collateral agreements and stock pledge agreements, which were not included in the report. These transactions were not included in Ms. Galvin's report because Panavision requested she specifically review only the two transactions identified as the subject of the report.

In preparation of the report, Ms. Galvin interviewed William Scott, Christopher Phillips and Jeff Marcketta, and reviewed a large number of documents, including the company's 10-K, financial statements, tax returns, intercompany agreements and bank transactions. Ms. Galvin chose to apply the Final Treasury Regulation § 482 as the IRC regulation for her analysis, which applies to tax years after October 6, 1994. The portion of the regulations as relevant to this

matter have not changed significantly since their original adoption, which precedes the 1991 transactions.

IRC § 482 is used to determine the arm's length transfer prices for transactions between members of an affiliated group. This is done to clearly reflect income attributable to controlled transactions. The final section 482 regulations provide several methods for determining intercompany prices, and require the "best" method be employed for each pricing situation, i.e., the method that produces the most reliable measure of an arm's length result for the controlled transaction, considering all of the facts and circumstances of that transaction. Although the report discussed five tangible assets' pricing methods,[5] the report employed the Benefit Test of Treasury Regulation § 1.482-2(b), which provides guidance on how to determine the arm's length charge for services performed by a member of a controlled group for another member of the group. An arm's length charge must be paid if the tested party passes the Benefit Test.

The Benefit Test is a method by which an allocation is made when an entity benefits from services rendered by a related party. However, no allocation is made if the probable benefits are so indirect or remote that unrelated parties would not have charged for the service or if the service is merely a duplication of a service which the related party has independently performed or is performing for itself. The Benefit Test was used to analyze the management services provided by LPI to Panavision.

Ms. Galvin determined that LPI passed the Benefit Test for the following reasons:

* Benefits were expected from the services under review;

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[5] Since these pricing methods are not relevant to Ms. Galvin's analysis and conclusions, they are not discussed herein.

* The services under review which LPI provided to Panavision were not a duplication of other services; and

* The services under review were of a type for which an unrelated party would have charged.

In order to calculate an arm's length management fee, Ms. Galvin first determined the underlying costs incurred by LPI in providing these services. One method of determining such costs is to calculate the amount of time spent by employees in providing such services and to develop an allocation methodology based on time spent providing services to different entities. However, since time records for each executive were not maintained, and none of the LPI employees, other than Scott, were still employed by the company, it was not possible to precisely determine the amount of time spent by each employee rendering different services to different entities. Based on interviews with Scott, Marcketta and Phillips, Ms. Galvin derived the following percentages for stewardship services: McGonigle, 50%; Goldner, 50%; Buchner, 100%; and Dignam, 25%, for which an allocated expense would not be made to Panavision. Stewardship services, those which are duplicate in nature, tend to be services that a company or investor would undertake as an investor-related company that would not directly benefit the subsidiary or related companies. Stewardship services are the services one provides in the regular overseeing of the operations of a company, distinguished from general management and day-to-day services, which could provide a direct benefit. Stewardship services were provided to each of the Lee group entities at one time or another.

After the stewardship percentages were determined, the relevant percentage of each person's 1991 annual salary was allocated as to stewardship. Stewardship services over total

salary as a fraction was equal to 16%, which was used to determine what percentage of LPI's total expenses for the five-month period ended May 31, 1991 should be allocated to stewardship.

All of LPI's operating expenses incurred for the five months ended May 31, 1991 ($1,138,720.00) were set forth in a schedule, less stewardship expenses (16% of total expenses). The following expenses comprised this schedule: compensation of officers, salaries and wages, rents, depreciation, taxes, travel and entertainment, professional fees, travel expense, bank fees, office expense, temporary services, messenger and delivery services, consultants, telephone, miscellaneous, equipment rental, employment agency fees, and electricity. LPI's total costs less stewardship expenses was pro-rated to each of 16 companies in the Lee group,[6] including Panavision, based upon the relationship each subsidiary's five-month sales (ending May 31, 1991) had to the consolidated group's five-month sales.[7] Based upon this method, Ms. Galvin allocated to each of the 16 entities a share of the costs incurred by LPI in providing management services for the five months ended May 31, 1991. Costs in the amount of $507,000.00 incurred by LPI were attributed to providing management services to Panavision, and this amount was determined by Ms. Galvin to be an arm's length fee for these services.

The expert's report applied Treasury Regulation § 1.482-2(a) in the analysis of intercompany loans. Such regulation provides that where one member of a group of controlled entities makes a loan or advance and, as in this case, charges no interest, an allocation which reflects an arm's length rate of interest for the use of such loan or advance may be made. The

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[6] The companies included are the following: Lee Colortran, Shepperton Studios, Panavision Espana, Lee Lighting (UK), Lee International, Ltd., Lee International, Inc., Lee Panavision, Ltd., Humphries Holdings, Lee Lighting America, Colortran, Ltd., Lee America West , Lee Colortran Holdings, Lee International Acquisitions, Lee International Films, MRI, Ltd. and Panavision.

[7] Panavision's pro-rata portion of total expenses was approximately 53% based on this ratio.

regulations further provide guidance on the concept of an arm's length rate of interest. The arm's length rate is the rate that would have been charged at the time that the indebtedness arose in independent transactions with or between unrelated parties under similar circumstances. It considers relevant factors such as the principal amount, loan duration, security involved, credit of the borrower and the interest rate prevailing at the site of the lender or creditor for comparable loans between unrelated parties. Ms. Galvin sought to determine a market rate which would have been charged to LPI for borrowing a similar level of funds from an unrelated party during the same period. The borrowing rate which LPI would have paid during this relevant time period was estimated. The prime rate, which is typically given to corporations with AAA credit ratings was not deemed comparable as an implied rating for LPI for the period 1989 to 1991 because LPI had defaulted on its loans in 1988, and was still in default in 1991. Thus, Ms. Galvin made an adjustment to the applicable average prime rate to reflect the credit risk which would have been borne by Panavision or a third party lending to LPI. The adjustment was calculated by evaluating the average spread between AAA corporate bonds and CCC corporate bonds over a number of years, to obtain a normalized average spread, based on reliable and available data. Ms. Galvin determined that the prime rate during the relevant period ranged from 8.50% to 10.87%, to which she added a credit risk adjustment of 8.76%, yielding a prime rate with credit risk adjustment built in of 17.26% to 19.63%. These final amounts approximate a market borrowing rate a third party was likely to demand for lending funds to LPI during 1991. The interest rates as described were applied to the outstanding balance of cash which Panavision had transferred or loaned to LPI, which on January 1, 1991, was $18,215,508.00. This balance was calculated based on cash transfers from Panavision in the amounts of $8,975,000.00 and

$4,600,000.00 in 1989 and 1990, respectively, added to which was compounded interest on the balances based on adjusted market rates of 19.63% and 18.77%, respectively. The total arm's length compounded interest owed to Panavision from LPI for the period January 1, 1991 through May 31, 1991 was calculated to be $1.58 million. Ms. Galvin concluded that the transaction was not arm's length since LPI paid no part of the $1.58 million of interest to Panavision.

The only income earned by LPI during 1991 was interest and dividend income.

The parties stipulate that the following seven agreements existed concerning petitioner and were made a part of the hearing record:

a) Pledge Agreement dated October 13, 1987;

b) Pledge Agreement dated February 17, 1988;

c) Guaranty Agreement dated October 17, 1987;

d) modification of the Guaranty Agreement dated February 17, 1988;

e) Guaranty Agreement date February 17, 1988;

f) Collateral Agreement dated February 17, 1988; and

g) Cash Collateral Agreement dated February 17, 1988.

Additionally, a copy of petitioner's board meeting minutes concerning Panavision's participation in the reorganization of LPI was also made a part of the record.

Prior to the 1991 reorganization, LPI was considering filing for bankruptcy due to its difficulty paying creditors. The 1991 reorganization plan included negotiations with the debtors and creditors of Panavision and LPI. The successful completion of the debt restructuring was announced on June 10, 1991.

We make the following additional finding of fact:

> The expert report submitted by Panavision, Inc., which analyzed intercompany transactions between LPI and Panavision to determine their arm's length nature, was prepared by Ernst & Young, LLP, the firm which prepared petitioner's tax returns for the audit period and now represents it before the Division of Tax Appeals.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In dealing with the issue of whether the statute of limitations should prevent the Division from assessing Panavision, the Administrative Law Judge determined that it does not. The Administrative Law Judge first dismissed the Division's argument that petitioner's failure to set forth the statute of limitations as an affirmative defense in its initial pleadings prohibited petitioner from raising it subsequently. The Administrative Law Judge noted that the Division was on notice of the defense prior to hearing and that there was a trial of the issue by express consent. Therefore, the defense was treated as if raised in the petition and not waived.

Although allowed to raise the affirmative defense, the Administrative Law Judge rejected petitioner's argument that ***Matter of Turbodyne Corp.*** (Tax Appeals Tribunal, July 3, 1996, ***confirmed Matter of Turbodyne Corp. v. Tax Appeals Tribunal***, 245 AD2d 976, 667 NYS2d 105, ***lv denied*** 91 NY2d 812, 671 NYS2d 715) controlled the outcome of the instant matter. In ***Turbodyne***, the Appellate Division held that once the statute of limitations expired for one member of a combined group the Division could not include that closed-year member to generate an additional assessment for the remaining open-year members of the group and the open-year members of the group could not revive the closed-year member to generate a refund (***see***, ***Matter of Turbodyne Corp. v. Tax Appeals Tribunal***, 245 AD2d 976, 667 NYS2d 105).

The Administrative Law Judge did not extend this reasoning to the instant matter, where the open-year company was assessed as a separate company potentially adversely affecting the

other closed-year members of the group. The Administrative Law Judge held that the Division was not prohibited from assessing Panavision during its open period of assessment and after the combination request was made during the same open period for all the other entities.

The Administrative Law Judge also determined that the Division properly assessed petitioner as a separate entity because the combination criteria were not present. These criteria were defined by the Administrative Law Judge as a stock ownership test, a unitary business test, and a distortion of income test. The parties stipulated to the stock ownership requirement but the Administrative Law Judge found that Panavision did not establish that it was part of a unitary business with the other entities, failing to demonstrate functional integration, centralized management and the achievement of economies of scale. On this basis, the Administrative Law Judge determined that the Division properly assessed petitioner on a separate filing basis.

In the alternative, the Administrative Law Judge found also that petitioner failed to demonstrate that filing on a separate basis would cause distortion of petitioner's activities, business, income or capital in New York State. Although petitioner tried to establish distortion through the absence of arm's length pricing and the absence of interest charges on its loan's to LPI, the Administrative Law Judge rejected the first as based on flaws in the transfer pricing report and the latter based on a failure to establish that the cash transfers to LPI were loans.

Finally, the Administrative Law Judge concluded that petitioner did not establish reasonable cause for the abatement of penalty or that it acted in good faith, and sustained the penalties imposed.

ARGUMENTS ON EXCEPTION

The issues on exception are the same as those raised before the Administrative Law Judge. Petitioner argues that the Administrative Law Judge misapplied ***Turbodyne***, which it believes directly prohibits the assessment of additional tax against Panavision by the Division where the period of limitations has closed for all other members of the group.

Petitioner maintains that the Division erred in its decision to compute its tax liability on a separate basis because it was part of a unitary business with other members of the LPI group and filing of a separate return distorted the income, activities, business and capital attributed to New York. In support of this position, petitioner contends that LPI provided management services to Panavision and that other members of the group used cash received from petitioner to fund ongoing business operations. In addition, petitioner argues that if the Division is permitted to force it to file on a separate basis, distortion will result.

Finally, petitioner believes that even if all other issues are resolved against it, penalties should be abated since it had reasonable cause for filing on a combined basis with the other members of the group given what it characterizes as substantial intercompany transactions. Further, petitioner argues that since combination is discretionary in the Commissioner of Taxation and Finance, it is not a proper situation for the imposition of penalties.

The Division rejects petitioner's application of the ***Turbodyne*** case, contending that Panavision was never a member of the combined group and was assessed as a separate entity. The Division adds that the combined group never requested prior approval to file on a combined basis with petitioner. Subsequently, on audit, the Division determined that Panavision did not meet the requirements for filing on a combined basis with the rest of the group, i.e., it failed to

demonstrate that it was part of a unitary business with the combined group. In support of this position, the Division argues the points set forth by the Administrative Law Judge in the determination. In addition, the Division contends that petitioner has not shown that its income would be distorted by filing on a separate basis. The Division points out that petitioner conceded a lack of substantial intercorporate transactions between itself and Lee International, thus, vitiating the presumption of distortion. Therefore, it was incumbent on petitioner to demonstrate the adverse effect.

The Division also argues that combination is inappropriate given the distortion which would occur if the adjustments for management services and interest income as proposed by petitioner's expert were incorporated on a combined as opposed to a separate return. In addition, the Division emphasizes that petitioner historically filed on a separate basis and depreciated its assets on a separate basis as well. However, in 1991, petitioner realized gains of over $82 million dollars on the sale of assets and seeks to offset this gain against the losses of other members of the combined group. The Division believes this would result in a large distortion.

Finally, the Division contends that penalties should be imposed based on petitioner's substantial understatement of liability and its failure to establish reasonable cause or that it acted in good faith. The Division cites petitioner's failure to request permission to file on a combined basis, its lack of intercorporate transactions and its mischaracterization of management services and loans in support of its position.

OPINION

We direct our attention first to whether the Division properly determined that petitioner should file its New York State corporation franchise tax reports on a separate basis. Petitioner's

argument that the law and regulations do not permit the imposition of tax on the basis of a separate return when the periods of limitation for other members of the combined group have expired is in error and its reliance on the ***Turbodyne*** case is misplaced. First, the focus of the ***Turbodyne*** case was the timing of the request to combine where the period of limitations had closed for all members of the combined group except petitioner. The Division conceded that the necessary requirements were present for combination, but denied the request due to the closed periods of limitation. The Appellate Division confirmed the Tax Appeals Tribunal's decision, which found that the combined report was a return for purposes of Tax Law §§ 1083(a) and 1087, and the filing of the report was appropriate only where the statutes of limitations remained open for all members of the combined group (***Matter of Turboyne Corp. v. Tax Appeals Tribunal***, ***supra***). The Appellate Division was concerned that ignoring the fact that the statutes of limitations had closed for members of a combined group would lead to the Division resurrecting them to generate additional assessments or the petitioner doing the same to generate a refund. This was not the case with Panavision.

In the instant matter, petitioner was one of seven companies that had timely requested the Division's permission to combine (***see***, ***Matter of Autotote Ltd.***, Tax Appeals Tribunal, April 12, 1990 [where the Tribunal rejected the Division's refusal to permit combined reporting based solely on the petitioner's failure to timely file a request pursuant to 20 NYCRR former 6-2.4(a)]). The request accompanied the combined return, filed on December 15, 1992, when the statute of limitations for each of the seven members of the proposed combined group was open and was considered timely consistent with the decision in ***Matter of Turbodyne Corp. v. Tax Appeals Tribunal*** (***supra***). Petitioner's request to combine was denied after an audit revealed

that it did not meet the requirements for doing so as set forth in Tax Law § 211(4) and the regulations at 20 NYCRR 6-2.3 and 6-2.4. Refusing to allow petitioner to be included in the combined group after an audit was within the discretion granted to the Division by Tax Law § 211(4) and 20 NYCRR 6-2.4(c). It is also distinctly different from ***Turbodyne*** where the request to combine was late but the requirements for combination were met.

The Division began an audit of petitioner in 1995, securing the first consent to an extension of the period of limitations on assessment from petitioner in April of 1995, eight months before the statute of limitations closed for all members of the combined group (Tax Law § 1082[a]; 20 NYCRR 8-1.2[a]). This provided ample notice to all members of the group that petitioner's return for the year 1991 was under audit, the results of which might impact the combined group and its report. However, none of the combined group filed protective claims or otherwise notified the Division. Petitioner's protestations with respect to potential adverse consequences for the other members of the group are unfounded. Consistent with the Appellate Division's concerns in ***Turbodyne***, it did not attempt to assess tax against any member of the group for which the statute of limitations has closed and it certainly did not prevent them from claiming refunds or taking prophylactic action once the audit of Panavision had begun. After all, it was ultimately the combined group that failed to demonstrate that Panavision should be included in the combined group, and the Division should not be responsible for the ramifications of that failure. For the same reason, we reject petitioner's argument that certain items of income, loss and deduction would be subject to double taxation.

We next turn to the issue of whether the Division properly determined that petitioner should file its New York State corporation franchise tax report for 1991 on a separate basis. In ***Matter of Autotote Ltd.*** (***supra***), we said:

> Tax Law Article 9-A imposes a tax on foreign corporations doing business in New York on the basis of the business they generate in the State (Tax Law section 209.1). In order to properly reflect that tax liability, Tax Law section 211(4) authorizes the Division to require or permit corporate taxpayers subject to New York State tax to file combined reports with other corporate taxpayers irrespective of whether such corporations are doing business in the State, where: the parent owns or controls substantially all of the stock of the subsidiary; the corporations are, in substance, part of a unitary business conducted by the entire group of corporations; and if, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income (***Matter of Campbell Sales Co. v. State Tax Commn.***, 68 NY2d 617, 505 NYS2d 54, 54-55; ***see also***, ***Matter of Wurtlitzer Co. v. State Tax Commn.***, 35 NY2d 100, 358 NYS2d 762; ***Matter of Coleco Industries v. State Tax Commn.***, 92 AD2d 1008, 461 NYS2d 462; 20 NYCRR 6-2.5[a]).
>
> The Division's current regulations, effective for all taxable years ending on or after December 31, 1983, follow the case law and provide that the Division may require or allow the filing of combined reports where the three conditions of the regulations have been 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).

As indicated by the Administrative Law Judge, there is no dispute that petitioner met the stock ownership requirement (***see***, 20 NYCRR 6-2.2[a]). However, the Administrative Law Judge determined that Panavision was not part of a unitary business, consistent with the guidelines set forth in the Division's regulations at 20 NYCRR 6-2.2(b). Given the facts in the record, we must agree with this conclusion.

The constitutional prerequisite to a finding of a unitary business is a flow of value and the test analyzes functional integration, centralization of management and economies of scale. Further, evidence of these elements include lack of arm's length transactions and a management

role by the parent corporation reflecting its own operational expertise and strategy (***see, Matter of British Land [Maryland]***, Tax Appeals Tribunal, September 3, 1992, ***confirmed Matter of British Land [Maryland] v. Tax Appeals Tribunal***, 202 AD2d 867, 609 NYS2d 439, ***revd on other grounds*** 85 NY2d 139, 623 NYS2d 772).

Petitioner continues to argue on exception that Panavision's cash management and the provision of management services by LPI satisfy the requirements for a unitary business. The "cash management" of Panavision entailed a sweeping of its rich cash accounts by LPI to defray the debt of other members of the group. Although petitioner now argues that these were bona fide loans, there was conflicting testimony concerning the expectation of repayment of the debt and clear evidence that Panavision had no ability to demand it. The Administrative Law Judge acknowledged that a flow of value might have been established by petitioner's pledge of stock as collateral for the Lee group debt, but rejected that notion in light of the fact that LPI purchased petitioner as an investment, not to further its operational function. LPI's operational function was never involved with Panavision's business of designing, manufacturing or leasing camera equipment and the conclusion was that its profits were being taken by LPI as a constructive dividend. Petitioner relies on two of our cases to support its position that it was involved in a unitary business with LPI.

Although petitioner argues strenuously that the facts in this matter are significantly similar to those in ***Matter of Heidelberg Eastern*** (Tax Appeals Tribunal, May 5, 1994), such is not the case. In ***Heidelberg Eastern***, the companies seeking to combine shared several officers, directors and administrative staff, including the president; corporate management employees transferred freely between the companies; the parent company dictated budgeting procedures for

the subsidiary; the companies maintained an integrated cash management system, including a concentration account in the name of the parent which served as a depository for all funds received and where funds of the companies were commingled (but records were kept of contributions); the parent maintained a system for paying the subsidiary's suppliers; all day-to-day costs of the subsidiary were paid from the concentration account; the subsidiary borrowed from the concentration account rather than go to a bank but paid interest to the parent; the two companies purchased insurance and fleet vehicles on a combined basis; the two companies also purchased legal and accounting services together and shared an in-house counsel; the parent provided a guarantee for many of the subsidiary's real property and inventory transactions; the same individuals were responsible for personnel, management, labor negotiations, health benefits, pension benefits, real estate and office facility management. In addition, the two companies shared and coordinated trucking activities, where feasible, and the subsidiary produced printing materials for the parent. The subsidiary's unaudited financial statements specifically provided that the subsidiary's financial position could be fairly stated only when the consolidated financial statements of the parent were taken into account, because of the considerable savings achieved through consolidated borrowing and joint purchasing, and did not reflect the contributions made by each company to the other. We found a unitary business based on that evidence, finding an "umbrella of centralized management and controlled interaction" between the two companies, where each company engaged in activities related to the other (***see***, ***Exxon Corp. v. Wisconsin Dept. of Revenue***, 447 US 207, 65 L Ed 2d 66, 81).

This was not the case with Panavision and LPI for the very reasons so thoroughly discussed by the Administrative Law Judge. The "cash management" and management services

provided by LPI did not remotely approach the levels present in the ***Heidelberg Eastern*** case. In addition, the financial exigencies distinguish this matter since a finding of functional integration would involve an interpretation of the facts and circumstances unmindful of the dire straits in which LPI and the Lee group found themselves. As the Administrative Law Judge noted:

> LPI's concern was simply to stay afloat, and that goal had nothing to do with any interplay between parent and subsidiaries to foster corporate expansion or profitability by a transfer of funds on a non-arm's length basis that would lead to a conclusion that LPI and Panavision were functionally integrated (Determination, conclusion of law "H").

Although Panavision contends that LPI's contribution to its management reflected LPI's operational expertise and strategy, that is not supported by the evidence in the record. Panavision's own strong and successful management team, which received praise from LPI's chief executive officer, was left to continue its successful ways, while LPI went about the business of "rationalizing" the assets of the group. LPI's role was strictly oversight and did not rise to the level of centralized management.

Finally, we see no evidence of economies of scale, other than the one instance cited by the Administrative Law Judge of the sharing of space by Lee Lighting America and Panavision in Orlando, Florida, which would indicate the existence of a unitary business among members of the group. In sum, petitioner has failed to establish a unitary relationship.

Petitioner's reliance on ***Matter of Mohasco Corp.*** (Tax Appeals Tribunal, November 10, 1994) was also misplaced. In ***Mohasco***, we found that the provision of engineering and transportation services, review of capital acquisitions, the procurement of cash and performance of budgeting services established the existence of a unitary business. Once again, the parent and subsidiary shared officers and directors, but the parent set administrative policy for the

subsidiary, including tax and risk management policies. The parent corporation borrowed all funds to finance the operations of its subsidiaries. In addition, the parent received all cash receipts on behalf of its subsidiaries, but then deposited said receipts into each subsidiary's account. In addition, the parent and its subsidiaries shared the costs of engineering, including salaries, public relations, distribution services, legal services and a human resource director. The parent handled the pension plan as well as the health and accident insurance for itself and its subsidiaries. These indicia of a unitary business are not present in this matter, thereby failing to establish functional integration among the companies, centralized management and economies of scale.

We note that the circumstances in this matter are unique. LPI was controlled by Citicorp and other creditors as of 1988, when the group was in default on very substantial loans for which the stock of all the companies had been pledged as collateral. Citicorp enticed a fund management group, Warburg Pincus, to invest and participate in the operation and restructuring of the group. Warburg brought in Mr. Scott and charged him with "cleaning up" the group. Loosely translated this meant selling off the unprofitable companies and shoring up the rest. When viewed in this context, the analogy between Panavision and either ***Heidelberg Eastern*** or ***Mohasco*** for support of the notion of a centralized management is baseless. The goal herein was to strip as much cash from the profitable Panavision as possible to pay down the significant debt of the group and there is no evidence that it was to be repaid at any time. We agree with the Administrative Law Judge that little or no benefit accrued to Panavision as a result of the cash sweeps by LPI.

In ***Matter of Autotote Ltd. (supra)***, we stated:

> The regulations provide a standard pursuant to which the discretion of the Division is to be exercised (***Montauk Improvement, Inc. v. Procaccino***, 41 NY2d 913, 394 NYS2d 619). The distortion of income test contained in 20 NYCRR 6-2.3(a) provides that the Division of Taxation ". . . 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." (Emphasis added.) "If a taxpayer meets the presumption of distortion because it has substantial intercorporate transactions . . . and if the filing of a report on a separate basis does not result in a distortion of such taxpayer's activities, business, income or capital in New York State, then the [Division] will not permit or require the filing of a combined report" (20 NYCRR 6-2.3[d]). In considering whether there are substantial intercorporate transactions, the Division of Taxation will consider transactions directly connected with the business conducted by the taxpayer (20 NYCRR 6-2.3[c]).

The Administrative Law Judge found and we agree that there was an absence of intercorporate transactions in this matter, which in and of itself will not preclude a petitioner from filing on a combined basis. However, in such circumstances, reporting on a separate basis must cause distortion and the burden of proving that distortion of activities, business, income or capital falls upon the petitioner (***Matter of Mohasco Corp.***, ***supra***).

Petitioner attempted to show distortion through two sets of transactions which were analyzed in a report prepared by Ernst & Young, LLP, the firm which prepared petitioner's tax returns for the audit period and represented it before the Division of Tax Appeals. The report concluded that arm's length prices were not charged by LPI for management services provided to Panavision because Panavision did not compensate LPI for said services and, further, LPI paid no interest on cash advanced to it by Panavision during the period January 1, 1991 to May 31, 1991. The Administrative Law Judge found that any management services provided by LPI were already performed by Panavision's management team, thereby providing no benefit to

Panavision which would substantiate the value ascribed to such management services by petitioner's expert. In addition, the report of petitioner's expert was prepared from interviews with witnesses and documentation "hand-picked" by petitioner, casting doubt on the impartiality and independence of the report.

Mr. Farrand, the president of Panavision during the audit period was not made available, although he would have been in a position to attest to the management services provided to his company by LPI. Given the glowing remarks Mr. Scott made about his management capabilities, the failure to consult with Mr. Farrand in the preparation of the report was troubling, particularly in light of the fact that he was still employed by the company. We note, as did the Administrative Law Judge, deficiencies in the report attributable to the following: Mr. Scott's memory failures; the unreliability of Mr. Phillips' testimony based on his position at Panavision during the period in issue; the failure of the report to adequately substantiate the allocation of management services; the allocation of all of LPI's expenses to the computation of management services given the nature of its business; and the failure to explain why no allocation was made to 14 other related companies.

In addition, the Administrative Law Judge correctly rejected the distortion argument based on the intercompany cash transfers on which no interest was paid to Panavision. We concur with the Administrative Law Judge's conclusion that the transfers were not loans, rather constructive dividends. To consider them loans would infer a bona fide indebtedness which never existed here.

The issue of whether amounts paid to shareholders are dividends or loans is a factual issue and depends upon the good faith intent of the shareholders to repay the amounts received and the

intent of the corporation to require repayment (***Williams v. Commissioner***, 627 F2d 1032, 80-2 USTC ¶ 9550). In the case of a closely-held corporation, special scrutiny is required because of the unfettered control exercised by a limited number of shareholders (***Roschuni v. Commissioner***, 29 T.C. 1193, ***affd*** 271 F2d 267, 59-2 USTC ¶ 9748, ***cert denied*** 362 US 988, 4 L Ed 2d 1021).

Mere declarations by shareholders that they intended a transaction to constitute a loan are insufficient if the transaction fails to meet more reliable indicia of debt which indicate the "intrinsic economic nature of the transaction" (***Williams v. Commissioner***, ***supra***, 80-2 USTC ¶ 9550, at 84,788). In making the necessary factual determination, courts have looked to a number of objective factors including the following: (1) the extent to which the shareholders control the corporation; (2) the earnings and dividend history of the corporation; (3) the magnitude of the payments; (4) whether a ceiling existed to limit the amount of the corporate payments; (5) whether or not security was given for the payments; (6) whether there was a set maturity date; (7) whether the corporation ever undertook to force repayment; (8) whether the shareholders were financially able to repay the payments; and (9) whether there was any indication the shareholders attempted to repay the amounts received (***see***, ***Dolese v. United States***, 605 F2d 1146, 79-2 USTC ¶ 9540, ***cert denied*** 445 US 961, 64 L Ed 2d 236).

Given these indicia, we conclude that the facts of this matter demonstrate that the "cash sweeps" were nothing more than constructive dividends, not loans. Panavision was closely held by LPI, the beneficiary of the payments. Petitioner declared no dividends in 1991. The payments themselves were not evidenced by notes and were not scrutinized. Panavision received no repayments and no maturity date was established for repayment. The payments had

no established ceiling to limit their amounts and LPI was not in a financial position to repay nor was any attempt made to do so.

Failing to establish these two grounds for proving that separate returns would create a distortion of the portrayal of petitioner's income, capital, business or activities, the Division's refusal to permit petitioner to file on a combined basis was proper.

On the issue of penalty imposed pursuant to Tax Law § 1085(k) for substantial understatement of tax for 1991, petitioner has raised no new arguments which persuade us to alter the conclusion of the Administrative Law Judge. Petitioner has failed to demonstrate reasonable cause for its understatement of tax and that it acted in good faith, both of which are necessary elements pursuant to Tax Law § 1085(k). Petitioner's history of filing on a separate basis and the tenuous foundation it had for believing it could file on a combined basis in 1992, indicate the absence of reasonable cause and good faith.

The Division took an exception to two findings of fact of the Administrative Law Judge. Our review of the record indicates these findings are accurate. In addition, the Division excepted to certain language in conclusion of law "C" but agrees with the Conclusion in all other respects. Since we have reviewed this matter *de novo*, we deem the Division's exception to the language moot.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;
2. The exception of Panavision, Inc. is denied;
3. The determination of the Administrative Law Judge is affirmed;
4. The petition of Panavision, Inc. is denied; and

5. The Notice of Deficiency, dated April 20, 1998 is sustained.

DATED: Troy, New York
June 6, 2002

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner