STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
CS INTEGRATED, LLC	:	DECISION DTA NO. 817548
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1993 through 1997.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on May 9, 2002 with respect to the petition of CS Integrated, LLC, 701 Martinsville Road, P.O. Box 840, Liberty Corner, New Jersey 07938. Petitioner appeared by Edward M. Griffith, Jr., Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Clifford Peterson, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception, petitioner filed a brief in opposition and the Division of Taxation filed a reply brief. Oral argument, at the Division of Taxation's request, was heard on June 11, 2003 in Troy, New York.

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

ISSUES

I. Whether petitioner was the true owner and seller of certain inventory situated in New York such that the value of the inventory and receipts from sale of the inventory were properly included in petitioner's calculation of its business allocation percentage.

II. Whether the Division of Taxation properly imposed a substantial underpayment of tax penalty for the years 1993 through 1997 and, if so, whether penalties should be abated for reasonable cause shown.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "23" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner is a limited liability company organized under the laws of the State of Delaware. Its principal office is located in New Jersey.

On April 24, 1997, Christian Salvesen, Inc., ("CSI") was merged out of existence into petitioner.

During the tax years in issue, 1993 through 1997, CSI was primarily engaged in providing warehousing, refrigeration and cold storage services to the food industry. CSI would provide storage for a client's products and distribute those products to the client as needed. The distribution point was one of CSI's warehouses. The majority of CSI's business was conducted outside of New York State.

On June 13, 1989, CSI entered into an agreement (the "distributor services agreement") to provide warehousing and distribution services to one of its clients ("Company A"), a retail supermarket chain. At the time, CSI had no facilities in New York State. Pursuant to the agreement, CSI constructed a warehouse in Chester, New York. All of CSI's activities in Chester, New York were performed exclusively for Company A. Until 1991, CSI's activities for

Company A were restricted to the performance of refrigeration, cold storage and related services under the terms of the distributor services agreement.

At the time the distributor services agreement was entered into, Company A was experiencing substantial financial difficulties, and it continued to struggle financially after executing the agreement. Most of its cash was tied up in inventory and it was experiencing a cash flow problem. Company A approached CSI asking it to provide a loan to the company to finance Company A's inventory purchases.

CSI was reluctant to enter into a straight loan agreement. It did not want the assets of Company A, specifically the inventory which CSI was being asked to finance, to become available to all other creditors in the event of a Company A bankruptcy. To protect its interests, CSI negotiated an agreement (the "supplemental agreement") by which it would purchase the inventory of Company A located in the Chester warehouse and sell it back to Company A at cost plus a carrying charge. This arrangement was unique as CSI did not have such arrangements with any other warehouse customers.

The supplemental agreement between CSI and Company A, dated February 5, 1991, provided, in pertinent part, as follows:

> This letter will set forth our agreement regarding the distributor services to be provided by Christian Salvesen, Inc. ("CSI") to Company A:
>
> 1. CSI's Initial Purchase
>
> As of today, CSI hereby purchases and [Company A] hereby sells the frozen food and ice cream inventory currently located at the CSI Chester, New York warehouse facility and more particularly described in schedule A attached hereto exclusive of products bearing any [Company A] tradename [sic] or trademark ("[Company A] Brand Products") (the "Inventory"). The purchase price paid by CSI for the Inventory is $3,560,212.52, which amount represents the fair market value of such Inventory to [Company A] as also shown on Schedule

A. Receipt of the purchase price is hereby acknowledged by [Company A]. This Agreement shall constitute a bill of sale of the Inventory from [Company A] to CSI . . . .

* * *

2. CSI as [Company A] Exclusive Regional Distributor

[Company A] hereby agrees that CSI shall be [Company A's] exclusive regional distributor with respect to the types (not necessarily the brands) of products included in the Inventory as well as the types of products historically warehoused in CSI's Chester, New York facility for the benefit of [Company A]. Specifically, to the extent, from the date hereof throughout the term of this Agreement, [Company A] purchases any product of such type for ultimate sale within the New York Region (the "Region"), it shall purchase such products from CSI regardless of the availability (at equal or lower prices) of the same or similar products from competitors of CSI.

3. [Company A] Purchasing Assistance and Inventory Control

[Company A] agrees to purchase products at the request of CSI and immediately to resell to CSI at invoiced cost such products; provided the products are to be purchased from companies with which [Company A] will be placing an order within three months following CSI's request. . . . [Company A] agrees to provide, without any additional charge, inventory control assistance in the same manner and kind as has historically been provided by [Company A] at CSI's Chester, New York facility. . . .

* * *

4. CSI Agreement to Accommodate [Company A] Stocking Requirements

Subject to the provisions of this paragraph, CSI shall stock products in its inventory in accordance with advice and requests from [Company A] delivered from time to time. CSI will not be obligated to honor [Company A's] advice and requests to the extent that:

(a) the aggregate cost of the inventory (inclusive of the initial purchase pursuant to paragraph 1 of this Agreement plus additional purchases for that facility less amounts sold from that facility by CSI) would exceed CSI's then current budget levels. (CSI's current maximum inventory-carrying amount is $4.5 million);

* * *

8. Miscellaneous

A. Nothing in this Agreement shall be deemed to restrict the ability of CSI to sell any of the inventory or other products purchased from [Company A] to parties other than [Company A]. It is understood, however that [Company A] shall have priority as to availability of the Distribution Inventory.

* * *

C. [Company A] agrees to indemnify CSI for any liability (other than liability arising as a direct result of the negligence or willful misconduct of CSI) and for any and all liability or expenses, including without limitation expenses incurred in defending actual or threatened claims and litigation, in connection with the sale of defective or allegedly defective products.

The initial cap of $4.5 million on the cost of inventory was later increased to $5.35 million. For the initial and subsequent inventory purchases, CSI paid Company A directly, not Company A's suppliers.

By a second supplemental agreement dated June 24, 1997, Company A and CSI confirmed their mutual understanding that on termination of their relationship, Company A would pay to CSI "an amount equal to the consideration previously paid by CSI to Company A with respect to any remaining inventory . . . stored by CSI at any of its facilities."

Charges under the agreement were computed by CSI on a daily basis. If the dollar amount of product purchased from Company A exceeded the dollar amount of product sold to Company A on a given day, and the net increase was under the cap, CSI would owe Company A the amount of the net increase. If there was a net decrease in the amount of inventory, and the inventory was under the cap, Company A would owe the amount of the net decrease to CSI. An interest rate equal to prime plus 2.5 percent would be applied to the value of the ending

inventory on that day.[1] This amount would be divided by 365 to reach that day's carrying charge. Cash settlement of the daily charges was done on a weekly basis. CSI's purchases were never allowed to exceed the agreed upon cap.

The February 5, 1991 supplemental agreement between CSI and Company A supplemented, but did not replace, the June 13, 1989 distributor services agreement. During the tax years 1993 through 1997 CSI continued to charge Company A for warehousing, refrigeration, storage and handling of the inventory located at CSI's Chester, New York warehouse.

CSI filed New York State corporation franchise tax returns for the years 1993 through 1997. In calculating its receipts factor for business allocation purposes, CSI did not include receipts from the sale of inventory to Company A under the terms of the 1991 supplemental agreement. In addition, CSI did not include the inventory purchased from Company A in its property factor. CSI included payments made by Company A under the warehousing agreement and the amount of the carrying charges received from Company A in its receipts factor as New York receipts.

In each of its corporation franchise tax returns for the years 1994 through 1997, CSI included the following statement:

> The taxpayer has undertaken an inventory financing arrangement with an unrelated party. Accordingly, the taxpayer has only included the interest income (financing) in the receipts factor or other business receipts in New York State.

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[1] The calculation of the daily rate using a value of prime plus 2.5 percent was established by the testimony of Anthony Cossentino, Senior Vice President and Chief Financial Officer of CS Integrated. This value is consistent with the calculation of the carrying charge of 12 cents per case as agreed to in paragraph 5 of the supplemental agreement. A prime rate of 9.5 percent plus 2.5 percent equals 12 percent. Twelve percent applied to the average inventory balance of $4.5 million as agreed to by the parties equals $540,000.00. This amount divided by average annual volume of cases shipped (4,160,000) equals .1298, approximately 12 cents per case.

> The taxpayer is currently in the process of petitioning New York State for discretionary adjustment pursuant to the Regulations. The financing arrangement is unique and particular to New York. Actual business activities have properly included in the receipts factor as "Services Performed: and other business receipts.

In January 1995, Company A filed a petition for Chapter 11 protection from creditors in U.S. Bankruptcy Court. Later, in 1995, Company A emerged from bankruptcy.

In January 1996, the Division began an audit of petitioner's books and records for the years 1993 through 1997. At the initial pre-audit conference held on June 10, 1996, petitioner's representative informed the auditor that petitioner was then involved in a proceeding before an Administrative Law Judge in the Division of Tax Appeals (the "prior proceeding"). The auditor was provided with a copy of the 14-page reply brief filed by the petitioner in the prior proceeding. The issues raised in that proceeding related to petitioner's calculation of the receipts and property factors on the returns being audited.

As pertinent here, the reply brief provided to the auditor revealed that petitioner had filed a letter with the Division requesting a discretionary adjustment to petitioner's business allocation percentage for New York State corporation franchise tax purposes. This request was based on petitioner's contention that neither its sales of inventory to Company A nor the value of inventory covered by the agreement with Company A should be included in the calculation of petitioner's business allocation percentage. The Division denied petitioner's request for an adjustment. Petitioner then filed a claim for refund of the corporation franchise taxes paid for 1991 and 1992. It based its claim for refund on its claim that inclusion of the Company A receipts and property in its business allocation percentage resulted in distortion of its New York income. All of this information, along with petitioner's arguments before the Administrative Law Judge, were provided in the reply brief.

The auditor's handwritten audit log reveals that the Division took little action on the instant audit until the Administrative Law Judge determination was issued on October 31, 1996. The Administrative Law Judge decided all issues in favor of the Division and denied the petition.

The field audit then proceeded. Among other documents, the auditor reviewed petitioner's audited financial statements for two of the years at issue and petitioner's federal income tax returns. The inventory held in CSI's Chester warehouse was shown in the audited financial statements as being owned by CSI. Sales of inventory made by CSI to Company A were included in CSI's sales on its income statement. The same sales were reported on CSI's federal income tax returns. Based on these documents, the auditor determined that the receipts from sales to Company A and the value of the inventory held for sale in the Chester warehouse should be included in the calculation of petitioner's business allocation percentages for each of the audit years.

The Division adjusted petitioner's business allocation percentage for the audit years by including in its receipts and property factors, respectively, the gross sales and inventory values arising from the agreement with Company A. The Division then recomputed petitioner's corporation franchise tax liability and metropolitan transportation district surcharge using the higher business allocation percentage. The Division also imposed penalties for substantial understatement of tax due for each of the periods under audit.

The Division issued to petitioner a Notice of Deficiency, dated November 12, 1999, asserting deficiencies of corporation franchise tax and metropolitan transportation district surcharge totaling $2,406,055.00 for the fiscal years ending March 31, 1993 through April 24, 1997. For the same period, the Division asserted interest of $832,176.17 and penalty of

$241,518.90. Additional payments of $652,894.00 were applied to the balances due for the 1993 fiscal year. The total balance due as shown on the Notice of Deficiency is $2,826,856.07.

Petitioner timely filed amended returns for the final audit period which were audited by the Division after the issuance of the Notice of Deficiency. After audit of those returns, the Division and petitioner entered into a stipulation of facts setting forth the corrected audited amounts of additional tax, penalties, refunds and interest due for the audit period as follows:

Period Ending	Tax	Amount Due	Penalty	Interest	Total Due
03/31/93	Franchise	256,917.00	25,691.00	246,712.00	529,320.00
03/31/93	MCTD	37,979.00	3,797.00	38,701.00	80,477.00
03/31/94	Franchise	249,657.00	24,965.00	202,111.00	476,733.00
03/31/94	MCTD	17,330.00	1,733.00	14,257.00	33,320.00
03/31/95	Franchise	227,914.00	22,791.00	145,768.00	396,473.00
03/31/95	MCTD	12,077.00	1,207.00	8,246.00	21,530.00
03/31/96	Franchise	186,888.00	18,688.00	95,593.00	301,169.00
03/31/96	MCTD	9,807.00	980.00	5,016.00	15,803.00
03/31/97	Franchise	85,388.00	8,538.00	30,780.00	124,706.00
03/31/97	MCTD	4,146.00	-0-	1,495.00	5,641.00
04/24/97	Franchise	525,472.00	52,547.00	194,900.00	772,919.00
04/24/97	MCTD	29,014.00	2,901.00	10,761.00	42,676.00
04/25/97	Franchise	-581,901.00	-0-	-116,430.00	-698,331.00
04/25/97	MCTD	-70,993.00	-0-	-14,205.00	-85,198.00

We modify finding of fact "23" of the Administrative Law Judge's determination to read as follows:

> In the fall of 2000, Company A filed a second bankruptcy petition that led to the liquidation of most of its assets. Until January 2001, petitioner continued to do business with Company A in an attempt to reduce inventory and petitioner's losses associated with the inventory. Petitioner stopped doing business with Company A as of January 15, 2001. Petitioner filed a claim against Company A for repurchase of the existing inventory. It was ordered by the bankruptcy court to mitigate Company A's damages by reducing the inventory held by petitioner. Petitioner sought out potential purchasers for the inventory, primarily odd lot buyers who have purchased the inventory for 70 to 80 cents on the dollar.[2]

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination, the Administrative Law Judge recited the methodology prescribed by Tax Law § 210(3)(a) for calculating the property and receipts factors in order to allocate an appropriate amount of petitioner's entire net income to New York for purposes of the corporate franchise tax. The Administrative Law Judge noted that the issue for resolution concerned whether the inventory purchased and sold pursuant to the supplemental agreement should be included in either the property or receipts factors, respectively, of CSI.

The Administrative Law Judge concluded that although the supplemental agreement contained provisions consistent with a purchase and sale agreement, the overall terms of the supplemental agreement, the circumstances of the arrangement and the conduct of CSI and Company A established that the supplemental agreement was intended by the parties to be an inventory financing arrangement.

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[2]We modified finding of fact "23" to more accurately reflect the record.

The Administrative Law Judge found that the carrying charge was, in fact, a financing charge because it was based on the prime rate, the average inventory balance of products purchased by CSI and the annual average volume of cases shipped. The Administrative Law Judge concluded that the carrying charge was unrelated to the nature or the market value of the product. She also found that CSI had no opportunity to profit from a rise in the market value of the inventory while the inventory was in its possession nor did it have a risk of loss from a decrease in the value of the inventory. Further, the Administrative Law Judge noted that both CSI and Company A viewed the carrying charge as a fee for the use of CSI's money.

The Administrative Law Judge determined that while CSI was able to sell the inventory purchased from Company A to third parties, Company A had "priority as to availability of the Distribution Inventory" and sales of that inventory to third parties would breach the agreement. The Administrative Law Judge found that inasmuch as the expenses and liabilities arising from ownership of the property were retained by Company A, actual ownership of the inventory remained with Company A.

The Administrative Law Judge rejected the Division's argument that the Tribunal's decision in ***Matter of Christian Salvesen, Inc.*** (Tax Appeals Tribunal, April 2, 1998) should be accepted as "authoritative" because the issue in that case was different than the issues in the present case. However, the Administrative Law Judge noted that in ***Christian Salvesen***, the Tax Appeals Tribunal (hereinafter "Tribunal") affirmed the Administrative Law Judge's conclusion that the supplemental agreement between the taxpayer and Company A was a financing arrangement.

The Administrative Law Judge found certain principles in ***Matter of Tradearbed, Inc.*** (Tax Appeals Tribunal, January 12, 1989) and ***Matter of Emmerich Gallery*** (Tax Appeals Tribunal, March 30, 1995) relevant to determining whether a taxpayer is the actual owner of tangible personal property. Relying on these decisions, the Administrative Law Judge concluded that the supplemental agreement between CSI and Company A and the facts and circumstances of their relationship and business arrangements established that CSI was not the true owner of the inventory. The Administrative Law Judge also found that ***Paccar, Inc. v. Commissioner*** (85 TC 754, ***affd*** 849 F2d 393, 88-1 USTC ¶ 9380) supported CSI's claim that CSI was not the true owner of the inventory and that the transactions between CSI and Company A were not true sales.

The Administrative Law Judge found that the inventory served as collateral for CSI's loan to Company A. The Administrative Law Judge arrived at her conclusion, even though CSI included the value of the inventory in its calculation of its capital base on its New York franchise tax return, it included the same amounts as inventory on its federal income tax returns and in its own financial statements and CSI also included its sales to Company A in its calculation of gross receipts on its federal income tax returns and in its own audited financial statements. The Administrative Law Judge found that CSI had only a "nominal" ownership of the inventory and there was no statutory basis for including the value of the inventory in the calculation of petitioner's business allocation percentage.

ARGUMENTS ON EXCEPTION

In its exception, the Division argues that the Administrative Law Judge incorrectly concluded that CSI was not the owner of the inventory. The Division believes that the

Administrative Law Judge inappropriately looked beyond the terms of the supplemental agreement between CSI and Company A, ignored the parol evidence rule and ignored the form of that agreement. The Division asserts that the supplemental agreement was not a financing arrangement but a purchase and sale agreement by which CSI became the owner of the inventory. The Division maintains that the Administrative Law Judge's conclusion is contradicted by her own findings of fact. The Division insists that the form of the transaction chosen by the parties is controlling for tax purposes.

The Division argues that the cases relied on by the Administrative Law Judge as support for her analysis of property ownership, ***Matter of Tradearbed, Inc.*** (***supra***) and ***Matter of Emmerich Gallery*** (***supra***), are not relevant in that the taxpayers in those cases did not have full ownership rights to tangible personal property as did CSI herein. The Division maintains that CSI was the legal owner of the subject tangible personal property based on its rights arising from the supplemental agreement.

Further, the Division asserts that the Administrative Law Judge's reliance on ***Paccar, Inc. v. Commissioner*** (***supra***) is misplaced. The issue in ***Paccar*** concerned whether a transaction was a sale for purposes of determining an adjustment to a taxpayer's federal taxable income. The Division argues that it is not appropriate to rely on this case to determine if the subject transactions were sales for purposes of calculating CSI's New York receipts factor. Further, if ***Paccar*** requires a conclusion that the transactions between CSI and Company A were not sales, the Division believes that it also requires a conclusion that CSI erroneously considered such transactions as sales when it computed its federal taxable income.

The Division maintains that in her analysis of the substance of the supplemental agreement, the Administrative Law Judge erred by concluding that CSI was not the legal owner of the inventory. Instead, the Division maintains that the Administrative Law Judge analyzed the motivation for the contract; i.e., that Company A wanted CSI to loan it money and was willing to use its inventory as collateral for that loan. However, CSI needed to own the inventory to protect itself from Company A's potential bankruptcy.

Petitioner argues, in opposition to the Division's exception, that the Administrative Law Judge did not ignore the parol evidence rule in her analysis because testimony explaining the course of dealing of the parties to an agreement is allowed to determine the legal consequences of the agreement. Petitioner asserts that pursuant to UCC § 9-102(1), the Uniform Commercial Code applies to any transaction intended to create a security agreement and that the question of title is largely immaterial under the Commercial Code. Although petitioner acknowledges that the supplemental agreement transfers nominal title of the inventory to petitioner, it maintains that title is only one factor to take into account in determining the legal consequences of a contract under Article 9 of the Commercial Code. Petitioner argues that the specific conditions and circumstances at the time that the contract was made should be considered in determining whether the transaction is a security agreement or a sale.

Petitioner maintains that although it had nominal title to the inventory, such title placed it in a position to sell Company A's property in the event of bankruptcy to reduce its outstanding loan. Such nominal title did not constitute beneficial ownership for tax purposes.

Petitioner asserts that even if it were the beneficial owner of the inventory, it had no business receipts from the sale of such inventory for purposes of the receipts factor. Relying on

the federal definition in Treasury Regulation § 1.61-3(a) of "gross income" as the measure of a taxpayer's business receipts, petitioner contends that "gross income derived from business" is defined as "total sales, less cost of goods sold." Petitioner, therefore, claims that since it purchased the inventory at Company A's cost and resold it back to Company A at that same cost, it had no gross income from the sale of inventory for purposes of its receipts factor.

Petitioner maintains that penalties, whether or not properly imposed, should be abated as petitioner acted in good faith and has demonstrated reasonable cause.

In reply, the Division argues that the Administrative Law Judge elevated substance over form in her determination and that the form chosen by the taxpayer should take precedence over the substance of the transaction. The Division believes that the issue for resolution is not whether the transaction is a sale or a financing agreement under Article 9 of the Commercial Code nor whether petitioner had beneficial ownership of the inventory. Rather, the inquiry is whether petitioner owned the subject inventory. The Division asserts that petitioner owned the inventory such that it could sell it back to Company A.

The Division maintains that resort to extrinsic evidence in order to interpret the supplemental agreement is improper unless there is a finding that the language of the agreement is ambiguous. The Division claims that the Administrative Law Judge's reliance on the circumstances of the agreement and the conduct of the parties to interpret the agreement was erroneous.

The Division alleges that the Administrative Law Judge did not rely on substantial authority for her conclusions, in that she ignored the prior decision of the Tribunal in ***Matter of Christian Salvesen, Inc.*** (***supra***). The Administrative Law Judge found the facts in that case and

the present proceeding nearly identical, but found that the issues were different. The Division believes that the Administrative Law Judge should have relied on the Tribunal's conclusions in that prior proceeding regarding the purchase of inventory by CSI from Company A and the resale for a profit of such inventory back to Company A in arriving at her determination in this matter.

The Division argues that petitioner's position concerning the applicability of the definition of "gross income" in Treasury Regulation § 1.61-3(a) to the calculation of business receipts is totally misplaced. The Division maintains that the Legislature intended that the "receipts" used to compute the taxpayer's receipts factor pursuant to Tax Law § 210(3)(a)(2)(A) means receipts from the sales of tangible personal property. The Division believes that the definition of "gross income" provided by Treasury Regulation § 1.61-3(a) relates solely to computing federal taxable income for corporations in the "manufacturing, merchandising and mining industries" and is not appropriate for the allocation of petitioner's entire net income to New York State for corporate franchise tax purposes.

The Division claims that penalties were properly imposed and petitioner has neither demonstrated good faith nor reasonable cause for the abatement of penalties.

OPINION

For the years at issue, petitioner was subject to New York's corporation franchise tax which was computed upon the portion of its entire net income allocable to New York. This allocable portion is determined by multiplying petitioner's business income by its business allocation percentage ("BAP"). The BAP is based on three factors: property, receipts, and

payroll. Tax Law § 210(3)(a) provides for calculating the property and receipts factors (those in issue herein) as follows:

> (1) ascertaining the percentage which the average value of the taxpayer's real and tangible personal property . . . within the state during the period covered by its report bears to the average value of all the taxpayer's real and tangible personal property . . . wherever situated during such period . . . ,
>
> (2) ascertaining the percentage which the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its entire net income, arising during such period from
>
> (A) sales of its tangible personal property where shipments are made to points within this state,
>
> (B) services performed within the state . . . ,
>
> (C) rentals from property situated, and royalties from the use of patents or copyrights, within the state, . . . and
>
> (D) all other business receipts earned within the state, bear to the total amount of the taxpayer's receipts, similarly computed, arising during such period from all sales of its tangible personal property, services, rentals, royalties, . . . whether within or without the state; . . .

Pursuant to 20 NYCRR 4-4.1(a), "business receipts" means "gross income received in the regular course of the taxpayer's business, provided such receipts are includible in the computation of the taxpayer's entire net income for the taxable year."

The issue for decision is whether, in calculating CSI's property and receipts factors for use in computing petitioner's business allocation percentage for the years at issue, the inventory purchased by CSI from Company A pursuant to the terms of the supplemental agreement should have been considered as CSI's tangible personal property within the state and the receipts from the sales of such inventory to Company A should have been considered as sales of its tangible personal property within the state.

The resolution of this issue depends on whether or not the transactions between CSI and Company A resulting from the supplemental agreement consisted of sales by Company A of its inventory to CSI and subsequent resales by CSI of that same inventory to Company A or whether the supplemental agreement was merely a financing arrangement by which ownership of the inventory assets always remained with Company A.

It is clear to us that the transactions engaged in by the parties pursuant to the supplemental agreement were sales and resales of the subject inventory assets. As a result, we reject the conclusion of the Administrative Law Judge that the supplemental agreement was merely a financing arrangement between the parties to that agreement.

Despite the finding by the Administrative Law Judge that it was the intent of petitioner and Company A to engage in a financing arrangement, their agreement was structured as a sale by Company A of its inventory to petitioner and a sale by petitioner of these same inventory assets back to Company A. This structure, of course, was undertaken to give petitioner exactly the protection it ultimately received when Company A filed for bankruptcy in 2000. To conclude otherwise would be to ignore the clear language of the agreement.

In ***Matter of Tradearbed, Inc.*** (***supra***), we considered several indicia of a buyer-seller relationship in order to determine whether the taxpayer was a seller of the tangible personal property at issue therein. In her determination in the present matter, the Administrative Law Judge characterized such indicia as "not directly relevant here" but, instead, concluded that "[t]he supplemental agreement between CSI and Company A and the facts and circumstances of their relationship and business arrangements establish that CSI was not the true owner of the inventory" (Determination, conclusion of law "E").

Although the concern in ***Tradearbed*** was whether the taxpayer was a selling agent of its affiliated corporations or whether the taxpayer was a buyer and seller of goods, we think that the ***Tradearbed*** indicia of a buyer-seller relationship are instructive for our purposes, and we enumerate them below:

1. That the consignee receives legal title and possession of the goods.

2. That the consignee becomes responsible for an agreed price, either at once or when the goods are sold.

3. That the consignee can fix the price at which he sells without accounting to the transferor for the difference between what he obtains and the price he pays.

4. That the goods are incomplete or unfinished and it is understood that the transferee is to make additions to them or complete the process of manufacture.

5. That the risk of loss by accident is upon the transferee.

6. The transferee deals, or has the right to deal, with the goods of persons other than the transferor.

7. That the transferee deals in his own name and does not disclose that the goods are those of another.

Looking at each in turn, we find that based on the terms of the supplemental agreement, CSI received legal title and possession of the tangible personal property it purchased from Company A. We note that Tax Law § 210(3)(a)(1), in referring to the "taxpayer's real and tangible personal property . . . within the state" does not distinguish between nominal ownership and beneficial ownership, a distinction relied upon by petitioner.

It also appears that CSI was responsible for selling the inventory to Company A at an agreed price. However, if it sold such inventory to a third party, the supplemental agreement did not require CSI to account to Company A for the price at which it sold such inventory.

Although there was no completion work to be performed by CSI on the inventory, the risk of loss by accident was borne by CSI. While CSI devoted its Chester warehouse to storing products sold to it by Company A, there is no evidence in the record that CSI was prohibited from dealing with the goods of other retailers in that same warehouse. As to the final indicia, there is no direct evidence of whether CSI dealt with the property at issue in its own name. However, when considering the manner in which CSI disposed of its inventory following the bankruptcy of Company A, the Administrative Law Judge found as a fact that "Petitioner filed a claim against Company A *for repurchase of* the existing inventory. It was ordered by the bankruptcy court to mitigate Company A's damages by reducing the inventory held by petitioner. *Petitioner sought out potential purchasers* for the inventory" (emphasis added). This does not suggest that CSI was acting as an agent for Company A but, instead, was acting in its own name. Based on an analysis of the transactions between CSI and Company A in light of the indicia set forth in ***Matter of Tradearbed, Inc.*** (***supra***) as well as the clear language of the supplemental agreement, we conclude that Company A sold the tangible personal property at issue to CSI and that CSI, in turn, resold such property to Company A.

We are not dissuaded from this conclusion by petitioner's argument that, under Article 9 of the Commercial Code, the supplemental agreement merely created a security agreement in the inventory and that the transactions between CSI and Company A were not sales. First, we find no evidence from the language of the supplemental agreement that CSI was given merely a

security interest in the inventory, nor that a security interest was reserved in the subject inventory by Company A when it was sold to CSI. Paragraph "1" of the supplemental agreement states, in applicable part, as follows:

> "This Agreement shall constitute a bill of sale . . . from [ ] to CSI. [ ] represents and warrants that all of the Inventory is (i) hereby transferred free of any lien, *security interest*, encumbrance or other cloud on title and (ii) usable and salable in the ordinary course of business without discount for defect or obsolescence" (Exhibit "D," part of attachments labeled exhibit "B," emphasis added).

We also reject petitioner's argument that "business receipts" means total sales less cost of goods sold. As the Division argues, the definition of "gross income" provided by Treasury Regulation § 1.61-3(a) relates solely to computing federal taxable income for corporations in the "manufacturing, merchandising and mining industries" and is not appropriate for the allocation of petitioner's entire net income to New York State for corporate franchise tax purposes. Additionally, 20 NYCRR 4-4.1(a) provides that "business receipts" means "gross income received in the regular course of the taxpayer's business, *provided such receipts are includible in the computation of the taxpayer's entire net income for the taxable year*" (emphasis added). "Entire net income," pursuant to 20 NYCRR 3-2.2(a) is "presumed to be the same as the taxable income (but not alternative minium taxable income) which the taxpayer is required to report to the United States Treasury Department." The Administrative Law Judge determined that CSI included its sales to Company A in its calculation of gross receipts when computing its federal taxable income for the years at issue. Therefore, we agree with the Division that the "receipts" used to compute the taxpayer's receipts factor pursuant to Tax Law § 210(3)(a)(2)(A) means the receipts from the sales of petitioner's tangible personal property

and the receipts from the sales to Company A were properly included in the calculation of CSI's receipts factor.

Our conclusion herein is consistent with our prior decision in ***Matter of Christian Salvesen, Inc.*** (***supra***). There, we found that the inclusion of inventory from the taxpayer's purchase of tangible personal property from Company A and the receipts from the resale of such property to Company A in the taxpayer's business allocation factors did not require a discretionary adjustment under Tax Law § 210(8) to properly reflect petitioner's business activity within New York State and effect a fair and proper allocation of its income and capital reasonably attributable to the State. Rather, the Tribunal found that given the structure adopted by the taxpayer, it was properly taxed. While not specifically deciding the issue of ownership of the inventory, we did consider the nature of the supplemental agreement in order to determine taxability. The difference between the two cases is that in the earlier case, the taxpayer included in its receipts and property factors, respectively, the gross sales and inventory values arising from the supplemental agreement with Company A. In the present case, CSI did not include these gross sales and inventory values in computing its receipts and property factors for the years at issue.

The distinction noted by the Administrative Law Judge herein, that the Administrative Law Judge in ***Christian Salvesen*** found that the supplemental agreement was actually a "financing arrangement," did not prevent the Tax Appeals Tribunal from concluding that it was not an abuse of discretion for the Tax Commissioner to refuse to adjust the BAP to excise the gross sales and inventory values arising from the contract with Company A from the BAP factors. In that decision, we stated that:

> Additionally, we conclude that the scheme created by petitioner to insure its financial stake in its New York operations was a direct response to the fiscal condition of its chief customer, Company A. In order to maintain its refrigeration, storage and related services operations in New York and preserve the profits it took therefrom, it chose to purchase Company A's inventory and then sell it back to Company A at a profit, characterized by petitioner as a finance charge. By purchasing the inventory, petitioner avoided the claims of any other creditor, which might have been raised if Company A had become insolvent or adjudicated a bankrupt. It appears petitioner was reaping even more profits from its New York operations under the new arrangement, an advantage which cannot be overlooked. The fact that it also incurred more franchise tax was merely a by-product of its choice to structure its arrangement with Company A as it did (***Matter of Christian Salvesen, Inc.***, ***supra***).

There is no reason demonstrated why these two cases, dealing with the same taxpayer, the same supplemental agreement (albeit in successive years) and the same type of transactions, should produce drastically different taxable results.

As part of the Notice of Deficiency issued to petitioner, penalty was imposed for substantial understatement of tax due for each of the periods under audit. Tax Law §1085(k) provides that where there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to 10% of the underpayment attributable to the understatement. However, that section further provides:

> The amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer *if there is or was substantial authority for such treatment*, or any item with respect to which the relevant facts affecting the item's tax treatment are *adequately disclosed in the return* or in a statement attached to the return. The tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was *reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith* (Tax Law § 1085[k], emphasis added).

As the Administrative Law Judge decided the issue of ownership of the inventory assets in petitioner's favor, she did not consider the issue of penalty imposition or abatement. On

exception, petitioner argues that due to its requests for refund for 1991 and 1992, its petition with the Division of Tax Appeals based on the denial of those refunds and the decision of the Tax Appeals Tribunal concerning 1991 and 1992, the Division was aware of the allocation issues relating to the supplemental agreement when petitioner filed its franchise tax returns for 1993-1997. Petitioner also relies on TSB-A-88(2)(C) and TSB-A-88(21)(C) as providing substantial authority for petitioner's proposition that "gross income" means gross receipts less cost of goods sold. Petitioner maintains that CSI attached separate statements to its franchise tax returns for the years 1993 through 1997 disclosing CSI's position regarding the receipts factor. Finally, petitioner asserts that even if penalty were properly imposed, it should be abated because CSI acted in good faith in that it had applied for a discretionary adjustment to its business allocation percentage for earlier years than those at issue herein. Further, petitioner alleges that it had reasonable cause for its position, as that term is defined in 20 NYCRR 2392.1(g)(2)[3] in that at the time it filed its returns, there was a petition pending before the Division of Tax Appeals regarding the adjustment of its business allocation percentage.

The Division, in response, argues that CSI did not, in fact, attach statements to its tax returns for the years at issue which adequately disclosed its position with regards to inclusion of the value of the inventory purchased from Company A in its property factor and inclusion of the gross receipts from its sales to Company A in its receipts factor. The Division maintains that petitioner did not exhibit good faith in that the statement attached to its tax returns - that it was seeking a discretionary adjustment in its BAP - was false. Rather, the Division asserts that petitioner's position was crafted after the Tribunal ruled against it in ***Matter of Christian***

[3]This section of the Division's regulations was promulgated on July 26, 1999 with an effective date of August 11, 1999 which is a date after the years at issue in this proceeding.

Salvesen, Inc. (***supra***). Finally, the Division points out that pursuant to the Division's regulations in effect at the time that petitioner filed its returns for the years 1993 through 1997, 20 NYCRR former 46.1(d)(3) provided that in determining reasonable cause, a pending petition before the Division of Tax Appeals may constitute reasonable cause if it involves "a question or issue affecting whether or not the person or entity is subject to tax and/or required to file a return." The Division believes that neither issue is involved herein and, therefore, petitioner fails to meet the requirement for having demonstrated reasonable cause.

We agree. There is no evidence in the record that there was substantial authority for CSI's position taken in its returns for the years 1993 through 1997. Neither TSB-A-88(2)(C) nor TSB-A-88(21)(C), which concern including only the gain on the sale of Federal National Mortgage Association or Government National Mortgage Association certificates within gross income, supports CSI's position that Tax Law § 210(3)(a), requiring petitioner to use receipts from its sales of tangible personal property in calculating its receipts factor, means that only total sales less cost of goods sold are included in such receipts. Nor did the statement attached to petitioner's franchise tax returns for the years at issue adequately explain petitioner's position with regard to the calculation of its receipts and property factors on those returns. Finally, we find that petitioner failed to demonstrate "reasonable cause" for its position, as that term was defined in the regulations of the Tax Commissioner in effect at the time that the returns herein at issue were filed. As a result, we find that penalty was properly imposed on petitioner and there is no basis for its abatement.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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

2. The determination of the Administrative Law Judged is reversed;

3. The petition of CS Integrated, LLC is denied; and

4. The notice of deficiency, dated November 12, 1999, is sustained.

DATED: Troy, New York
November 20, 2003

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

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