STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
HALLMARK MARKETING CORPORATION	:	
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1999.	:	DECISION DTA NO. 819956

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 26, 2006 with respect to the petition of Hallmark Marketing Corporation, Tax Department #330, P.O. Box 419480, Kansas City, Missouri 64141-6480. The Division of Taxation appeared by Daniel Smirlock, Esq. (Clifford M. Peterson, Esq., and Jennifer L. Baldwin, Esq., of counsel). Petitioner appeared by Morrison & Foerster LLP (Paul H. Frankel, Esq., and Irwin M. Slomka, Esq., of counsel).

The Division filed a brief in support of its exception and a reply brief. Petitioner filed a brief in opposition. Oral argument, at the Division of Taxation's request, was heard on January 22, 2007 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 Division of Taxation properly required petitioner to file its corporation franchise tax report for the year 1999 on a combined basis with its parent, Hallmark Cards, Inc.

II. Whether petitioner has established reasonable cause and that it acted in good faith for the abatement of penalty asserted by the Division of Taxation pursuant to Tax Law § 1085(k).

FINDINGS OF FACT

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

1. Petitioner, Hallmark Marketing Corporation ("Marketing"), was a Delaware corporation headquartered in Kansas City, Missouri. Marketing was created as a wholly-owned subsidiary of Hallmark Cards, Inc. ("Cards") in 1963 and assumed principal sales functions for Cards at some point prior to the year in issue. Neither Cards nor Marketing was a publicly held corporation.

Rod Sturgeon, a Hallmark employee since 1974, senior vice president of the personal expressions group finance organization for Cards and vice president and director of Marketing, was the chief fact witness called to testify at hearing.

2. During the year 1999 (the "audit period"), petitioner solicited, both in New York and throughout the United States, sales of greeting cards and other "social expression" products manufactured by or on behalf of its parent corporation, Cards, pursuant to a Sales and Distribution Agreement, dated September 30, 1991, and amended January 1, 1997 and January 1, 1999. The agreement provided that petitioner would be the exclusive distributor of Hallmark and Ambassador products in the United States. In addition, petitioner manufactured display

fixtures used by retailers in the sale of the social expression products. Products were sold to retailers such as card and card specialty shops, grocery stores and department stores like Walmart, K-Mart and Target.

3. Following an audit by the Division of Taxation (the "Division") of petitioner's Article 9-A return, the Division adjusted petitioner's tax liability for the year 1999 by combining petitioner with Cards, and it issued a Notice of Deficiency, assessment number L-023521025-2, dated February 13, 2004. The notice asserted an additional liability for corporation franchise tax and for the Metropolitan Commuter Transportation District ("MCTD") surcharge, in the amount of $1,109,091.00, together with interest in the amount of $359,544.99 and a penalty for substantial understatement of tax liability pursuant to Tax Law § 1085(k) in the amount of $110,908.00, for a total amount due of $1,579,543.99.

4. The Division began its audit of petitioner in September 2001, spending four days in Kansas City in July of 2002 examining documents and meeting with employees. In September 2002, in response to a request for further transfer pricing documentation, petitioner sent the Division a copy of a report by KPMG which evaluated the transactions between Cards and petitioner. However, the report was not considered by the Division until December 10, 2003, when the auditor requested that higher level audit personnel review it. By December 12, 2003, the Division reached the conclusion that the report was "weak." In all, the auditor's log, recorded on Division form 220.5, indicated 28 entries prior to the issuance of the Notice of Deficiency, 10 of which involved meetings or conversations with petitioner, 3 of which concerned requests for information and documentation and 5 of which noted analysis of information. Entries in the log were punctuated with long periods of unexplained inactivity,

culminating with numerous requests for additional information and documentation in December 2003 and January 2004, including a six-page letter, dated January 2, 2004, seeking documentation, correspondence and supporting workpapers for the 2000 KPMG transfer pricing study.

5. Although petitioner had executed a consent to extend the period of limitation for assessment of franchise tax in June of 2003 permitting the Division to issue an assessment at any time prior to February 15, 2004, it would not agree to further extensions proposed in December 2003 and January 2004. Citing a lack of documentation upon which to decide the combination issue, the Division utilized the information it had collected over 29 months and issued its notice on February 13, 2004.

6. During the period in issue, Cards developed, designed and marketed social expression products, mostly greeting cards, which it marketed pursuant to the provisions of the aforementioned Sales and Distribution Agreement. The agreement provided that Marketing had the exclusive right to distribute its Hallmark and Ambassador branded products and other products in the United States, although Marketing was not prohibited from selling or distributing products produced by third parties. The 1991 agreement called for Marketing to pay Cards 84% of the suggested wholesale price of the merchandise purchased for resale, net of discounts, allowances and returns, where wholesale price meant 50% of the retail price of the products. Non-resale products were sold to Marketing at wholesale less discounts and allowances. Title and risk of loss of the products passed from Cards to Marketing upon the carrier’s arrival at the destination point, in this case the retailer, obviating the need for Marketing to maintain inventory or warehouses of its own or to incur delivery costs.

7. The 1991 agreement was subject to termination by either party on 90 days written notice, but not before September 30, 1992, and Marketing was prohibited from assigning any of its rights under the agreement without the prior written consent of Cards.

8. Pursuant to the agreement, Marketing agreed to use its reasonable efforts to promote the sale of Cards' products as widely as possible and to enhance the reputation and image of the Hallmark and Ambassador brand names. In addition, Marketing agreed to use the trademarks, copyrights and trade names belonging to Cards for the sole benefit of Cards.

The price paid by Marketing to Cards for products to be sold to retailers for resale was modified by an amendment to the 1991 Sales and Distribution Agreement on January 1, 1997 to reflect a price equal to 80.5% of suggested wholesale price net of discounts, returns and allowances. The second amendment, executed on January 1, 1999, provided that Marketing would pay Cards 79.8% of the suggested wholesale price for products.

9. Cards also had distributor agreements with several companies for the exclusive right to import, sell and distribute Hallmark products in international markets. Products sold to the international distributors were F.O.B. the source, either Cards' manufacturing facility or a subcontractor's facility, and the price was wholesale less a negotiated discount. International distributors agreed to notify Cards of any copyright or trademark infringement and assist in taking action, including legal action, to stop the unauthorized use. Additionally, distributors acknowledged that all trademarks, copyrights and trade names were the exclusive property of Cards and that they would not acquire any rights or title in them by virtue of the distribution agreement or their use of the trademarks, copyrights or trade names and that the use of same

inured to the benefit of Cards alone. Cards also agreed to provide the international distributors certain management services including:

a) marketing and merchandising advice, including its "system-matic" display and reorder merchandising system;

b) advice on pricing of products purchased under the terms of the agreement;

c) instruction on inventory control and other technical assistance;

d) training of the distributor's personnel at Cards' office;

e) supplying blueprints and samples of display fixtures, dividers, stock files, and related display items and assisting in locating display fixtures;

f) instruction regarding the use of the Hallmark and Ambassador trademarks on interior and exterior store signage; and

g) advice concerning the advertising and promotion of the Hallmark and Ambassador brands.

Distributor agreements with Gulf Greetings, dated April 26, 1995, Rakah Corporation, dated September 25, 1995, and Keaton International and Kids Kingdom, Inc., dated March 10, 1999, contained almost identical terms and were representative of the independent agreements Cards had with other distributors.

10. On October 1, 1991, Cards and Marketing entered into a Trademark License Agreement by which Cards granted Marketing a royalty-free, nonexclusive license to use, in the United States, the Hallmark and Hallmark Cards trademarks and trade names, alone and in combination with the "Coronet" design (the "licensed marks"), in connection with the manufacture of products by Marketing or its vendors, and the promotion, marketing, advertising,

distribution and sale of Hallmark branded products. In addition, Cards granted Marketing a royalty-free, nonexclusive license to use the trademark and trade name Hallmark as part of the trade name of social expression shops in the United States and to sublicense its rights to the owners of said shops.

11. Marketing conveyed to Cards all of its rights in any goodwill or other interest which arose as a result of its use of the licensed marks and agreed to maintain the standards of quality established by Cards for the use of the trademarks and trade names. In addition, Marketing was charged with performing trademark enforcement and quality control services, ensuring that the Hallmark brand was utilized in accordance with the standards developed by Cards. Marketing employees typically inspected signage, merchandising and color schemes in retail outlets in their efforts to assure that standards were being met. Marketing had the right to take legal action to prohibit unauthorized or unlicensed use of a licensed mark. As indicated above, Cards included similar provisions in its agreements with international distributors.

12. According to the 1991 Sales and Distribution Agreement, Marketing sold its products through a mass merchandise channel and the specialty/retail channel. The mass channel included “Expressions from Hallmark/Ambassador” stores and Walmart. The specialty channel included the retail Hallmark outlets, most of which were owned by independent third parties. Marketing sold to thousands of retail outlets.

13. In 1999, Marketing utilized five channels, which included the mass retail channel, card shops, corporate card shops, specialty stores and mass merchandise retailers. The mass retail channel was comprised of grocery stores, chain drug stores and department stores. The card shop channel included independently owned Gold Crown retailers. The corporate card

shops consisted of Specialty Retail Group stores. The specialty stores channel included bookstores, pharmacies and gift shops. The mass merchandise retailers included Walmart and K-Mart.

14. The mass channel consisted of both the mass retailers and the mass merchandisers. The mass retailers alone accounted for 76% of the retail outlets selling Cards' products in the United States, while the mass merchandise retailers constituted 8% of the outlets selling Cards' products in the United States.

15. Independent Gold Crown retailers constituted 9% of the retail outlets selling Cards' products. Gold Crown retailers were required to meet certain standards developed by Cards, such as purchasing a certain amount of overall stock from Marketing and primarily selling only Hallmark brand cards and products. In exchange, Gold Crown retailers were entitled to use the "Hallmark Gold Crown" on their storefronts.

16. In addition to the independents, Hallmark Specialty Retail Group, Inc. ("SRG"), a wholly-owned subsidiary of Marketing, operated about 350 Gold Crown stores, which represented about 1% of the retail outlets selling Cards' products in the United States. SRG operated these stores to establish stores in markets which were not large enough to support a Gold Crown store or to maintain stores after the owner left the business or passed away without a successor in place. Marketing's sales to SRG were on the same terms as its sales to unrelated Gold Crown retailers. Also, SRG test-marketed products and evaluated the viability of new retail concepts prior to general market implementation.

17. Independent specialty stores constituted 6% of the retail outlets selling Cards' products in the United States and included bookstores, individually owned pharmacies and gift

shops which neither displayed the Hallmark name on their storefronts nor primarily sold Hallmark brand products.

18. In 1999, Marketing employed about 1,500 people who helped carry out the functions of sales, collections and retailer service. Depending on the distribution channel, Marketing performed various services for retailers including submitting product orders to Cards on their behalf; providing training on the display of social expression products; packing, unpacking, and stocking products; and advising on store layout and space usage for its mass channel customers. In addition, Marketing also provided real estate services to Gold Crown retailers and other independent specialty stores, including store site selection and lease negotiation. The costs involved in providing stores with real estate-related advice was relatively minimal, only amounting to $2.3 million in 1996, $2.7 million in 1997, $3 million in 1998 and $3.6 million in 1999. Overall operating expenses for the period 1996 through 1998 were $364 million. Cards research developed and maintained the demographic modeling tools used in determining store locations.

Some job titles listed in the Hallmark Employee Identification System referenced locations in foreign countries. However, Vernon Clements, Operating Tax Manager for Cards, explained that these jobs were associated with Marketing only because it was the sole entity that could process the withholding taxes and file tax returns in all 50 states. In addition, Mr. Clements explained that once a title was listed in the system it could not be removed regardless of whether it was filled or not. Hence, the Employee Identification System was not a reliable list of current employees of Marketing.

19. Marketing assisted in the development of a software system called the retail operating model ("ROM") which was used to assist independent retailers with inventory control, performance reporting, e-mail and warehousing. Primarily, the ROM software was marketed to specialty retailers such as Gold Crown retailers who owned ten or more stores to help manage their complex businesses. Marketing and Cards shared the costs for the ROM software development, but the majority of the costs was subsequently borne by retailers.

20. Marketing did not advertise directly to consumers but did engage in a small amount of advertising to retailers in trade magazines and at retail trade shows. Its advertising expenses for 1999 were about $600,000.00. During 1999, Marketing produced catalogs which were sent directly to consumers of Gold Crown retailers, as a means of increasing sales at those stores. The cost of this catalog program was partially paid by the retailers. In addition, the retailers identified consumers who wished to join the Hallmark Keepsake Collector's Club. For a fee, these consumers were entitled to annual ornaments and advance notification of new products. The Cards advertising department decided what information would be imparted to these special consumers. Marketing helped facilitate the program at an unspecified level and at unspecified expense.

21. To facilitate distribution of product, Marketing both manufactured and purchased from third-party contract manufacturers (for which it had oversight responsibility) display fixtures for use in the retail stores and outlets to which it sold products, since fixtures were not generally available from third-party manufacturers. Marketing manufactured about 90% of the fixtures for use in the retail stores. Fixtures were loaned to the mass channel customers and sold

to the specialty channel stores. The fixtures were delivered to store and outlet locations and then installed.

22. Fixtures were an important part of the marketing of Cards' products because they enhanced the products' appeal. Many of the fixtures were lighted. The design of the fixtures was considered important and the conceptual design was created by Cards as a part of product development, since the fixture's design was dependent on the products to be displayed.

23. Following the design of the fixture by Cards, Marketing created the manufacturing specifications, with special attention to any individual needs of the retailer to whom the fixture was being delivered.

24. The materials for the manufacture of the fixtures were purchased from Cards pursuant to a Fixture Materials Agreement, dated January 1, 1996. Pursuant to the agreement, Marketing purchased the fixture raw materials at 5% of Cards' cost. However, Marketing's fixture manufacturing division operated at a loss, presumably as a service to promote Cards' merchandising and advertising efforts. The operating expenses attributable to fixture manufacturing were less than 5% of Marketing's total operating expenses. For 1999, fixture manufacturing accounted for $14.9 million in expenses while total expenses were $353.6 million.

25. As part of an advertising initiative, Cards developed the "Gold Crown Program" used at Gold Crown retail stores. Consumers were encouraged to sign up for a Gold Crown card which tracked purchases and rewarded higher volume purchasers with promotions and discounts. A database of cardholders was maintained by Cards for purposes of advertising.

26. Marketing had an additional subsidiary in 1999 called Retail Plans and Management, Inc., which held notes receivable primarily related to fixtures and troubled retailer loans.

27. In May 1999, Marketing entered into a receivables agreement to sell, irrevocably and without recourse, on an ongoing basis, all of its accounts receivable to Hallmark Funding Corporation (“HFC”). HFC funded its purchase of the receivables with a subordinated note.

28. HFC was incorporated under the Companies Law of the Cayman Islands on February 1, 1999 and was a wholly-owned subsidiary of H.A., Inc., a wholly-owned subsidiary of Cards.

29. In 1999, the receivables were sold at a discount of 19.9%, a rate which approximated the cost of returns, discounts, bad debts, allowances and the time value of money. The discount was recognized as a loss in 1999 of approximately $307,000,000.00.

30. Marketing recognized approximately $13,000,000.00 in interest income from HFC for the year 1999, an amount resulting from interest on outstanding monthly balances which accrued interest at a rate of 130% of applicable Federal rates. At the end of 1999, the outstanding borrowings from Marketing totaled $405,745,101.00, on which it incurred service costs of $3,693,810.00.

31. Marketing and Cards entered into an agreement, dated January 1, 1992, which provided that each would pay the other for services rendered in areas including finance, security, risk management, personnel, tax, accounting, data processing and building and ground management, also known as general and administrative expenses. The recipient of the services was charged a sum for the administrative service to compensate the provider of the services fully for all goods and services furnished.

32. In the Notes to Audited Financial Statements for Marketing for the year 1999, it was noted that the majority of the general and administrative costs incurred were paid by Cards and charged to Marketing at actual cost. These were specific charges relating to payroll, benefits and insurance which totalled $233,000,000.00. In addition, Cards charged Marketing, at actual cost, an additional $39,900,000.00 for occupancy and other administrative overhead items in 1999.

33. Understanding the importance of arm's-length transactions between Marketing and Cards and the impact on reporting requirements for New York State corporation tax purposes, Cards sought to set an arm's-length transfer price for products sold by Cards to Marketing.

34. Originally, the transfer price established for 1999 was based upon the 1998 price. However, in October 1999 KPMG was retained by Cards to evaluate and recommend a range of transfer prices for the 1999 tax year for the related party transactions between Cards and Marketing. Arthur Anderson, another national accounting firm, was the audit firm for Cards in 1999.

35. The principal author of the transfer pricing study, "An Evaluation of Transactions between Hallmark Cards Incorporated and Hallmark Marketing Corporation: Dealing Cards at Arm's Length," dated May 2000, was Ian E. Novos, Ph.D., a senior director at KPMG whose expertise was in the area of transfer pricing. Dr. Novos was well acquainted with the transfer pricing between Cards and Marketing because he had prepared a report for the years 1992 through 1994 which was used in a prior audit of Marketing by the Division, and which resulted in a settlement for the years 1992 through 1998. The earlier report was completed in September 1999. In October of 1999, KPMG was asked to prepare an arm's-length pricing report for 1999, which is dated May 2000. However, the results were provided to Cards in early 2000 so that it

could make year-end adjustments and reflect current arm's-length prices on the 1999 returns and financials.

KPMG used the functional analysis and interviews of several key individuals in the Hallmark group of companies from the prior report in addition to supplemental information regarding changes to the operations for the intervening period (1994 - 1998) as a foundation for its May 2000 report.

36. The report discussed the business operations of Cards and Marketing as set forth in the Findings of Fact listed above and, based upon the functional analysis performed, reviewed various methods listed in the regulations promulgated pursuant to Internal Revenue Code ("IRC") § 482 for determining the best and most appropriate methodology for determining the transfer price. KPMG determined that the comparable profits method ("CPM") was best. This methodology utilized objective measures of profitability, or profit level indicators ("PLI"), from uncontrolled businesses engaging in similar activities under similar circumstances. The proper arm's-length transfer price for the controlled corporations is then determined by looking to the operating profit the "tested party" would have earned on the related-party transactions if its PLI was equivalent to those of the uncontrolled businesses. PLI's are financial ratios that measure the relationships among profits, costs incurred or resources employed. The "tested party" for the PLI is the entity for which the most reliable criteria from uncontrolled comparables can be obtained. KPMG selected Marketing to be the tested party in this matter because it was principally a distributor of products that provided routine services for which it believed there were reliable data for a good number of uncontrolled comparables.

37. KPMG looked at and rejected other transfer pricing methods set forth in Treasury Regulation § 1.482-4 before selecting the CPM, to wit: the comparable uncontrolled price method; the cost plus method; the resale price method; and the profit split method. These, together with the chosen comparable profit method, are the five methods specified in Treasury Regulation § 1.482-4 for determining an arm's-length result for the transfer of tangible property between related parties like Marketing and Cards.

38. Besides the comparable profits method, only the resale price method was considered by KPMG to be a viable alternate transfer pricing method in this matter. However, reliability of the resale price method was considered less dependable where there were functional differences between the tested party and the comparables. In addition, the differences in accounting classifications of items between sales, cost of sales and operating expenses were more problematic for the resale price method where the impact on gross profit margins was more significant than on operating profit measures used in the comparable profits method.

39. KPMG sought a set of comparable distribution companies which were functionally comparable to Marketing in order to establish an arm's-length operating margin under the CPM. With the methodology chosen, KPMG then proceeded to choose comparables for Marketing from three databases containing financial information on publicly traded United States companies: Compact Disclosure, Mergent Company Data, and Standard and Poor's Compustat PC Plus. These databases compile and use data from the Securities and Exchange Commission ("SEC"), and one, Compustat, uses additional data from publicly available annual and quarterly shareholder reports and SEC Forms 10-K and 10-Q.

40. KPMG narrowed the number of comparables by beginning its search with wholesale distributors of nondurable goods based on the Standard Industrial Classification ("SIC") codes. These codes were developed by the United States government to promote uniformity and comparability in the presentation of statistical data. Then quantitative and qualitative screens were applied to the set of companies to find the best comparables available. Quantitative screens look to financial indicators while qualitative screens are based on the subjective judgments of screeners based on detailed information of each business. Each method is geared toward finding the most appropriate comparables possible.

41. Initially, KPMG identified 207 comparable companies to which it applied "screens" to filter out undesirable companies. Aware that a smaller set of comparables could lead to distortion, KPMG developed two sets of comparable distributors: a broad set which included distributors in general and a narrow set that reflected an in-depth analysis of each business. To compile the broad list, a quantitative screen was applied to the companies in the original set which eliminated those with an "advertising expense to total cost" ratio greater than 3%. This screen eliminated companies which spent significant resources on developing intangibles, something KPMG assumed Marketing did not do. Other quantitative screens applied to the original field of comparables were the elimination of companies with average sales under $20 million for the preceding three years and companies with less than two years of financial statement data. The $20 million cut-off was the product of a statistical test KPMG performed which indicated that $20 million was the point above which there was no significant relationship between the Berry ratio and average sales. In fact, companies with sales over $20 million had a higher median Berry ratio than those below $20 million. Therefore, there was a comfort level

with those comparables. After this screening process, KPMG was left with 101 distributor comparables from which arm's-length returns for distribution companies could be discerned with a high level of confidence, unaffected by distortion from a few anomalies.

42. The smaller, narrow set of comparables was obtained by applying screens to the broad set of comparables which analyzed information on the description of the business and SEC 10-K filings. Companies were rejected for several reasons: that they were inactive; did not distribute to retailers; had retail operations; manufactured; distributed prescription drugs or chemicals; provided medical services; or were foreign corporations or earned more than 20% of revenues from foreign operations. Since the SEC 10-K filings contained detailed descriptions of a company's business operations, more judgment was required on the part of the reviewer in determining whether a company should be rejected. After this analysis, nine companies remained as the final set of comparables, all of which were determined to have a greater degree of comparability with Marketing than the others.

Dr. Novos explained that it was important that the comparables chosen provide value added services and not possess nonroutine intangibles, or intangible property considered central to the conduct of business and without which the business could not be conducted.

43. In applying the comparable profits method, KPMG had to choose a PLI which demonstrated, for Marketing as the tested party and the nine comparables, the relationship between profits and sales, costs or resources employed. It chose the Berry ratio (gross profit/operating expenses) because it is often applied to a distributor whose cost of sales consists chiefly of the cost of purchasing goods that are then resold. The ratio assumed that the distributor's operating expenses reflected the level and intensity of the reselling functions it

performs, thus reflecting the return earned for performing these functions. KPMG concluded that Marketing was such a distributor of Cards' products and therefore chose to use the Berry ratio as a profit level indicator to evaluate the transfer prices Marketing paid to Cards and comparing the results to those of the comparables.

44. In determining whether Marketing's PLI was comparable to those of the comparables, KPMG utilized an interquartile range, or the range from the 25th to the 75th percentile of the results derived from the comparable uncontrolled companies.

45. KPMG's choice of the Berry ratio as the appropriate PLI reflected its belief that the value of the social expression products was less important than the services Marketing performed for Cards, especially given the mere momentary ownership of the products by Marketing.

46. As stated, after applying the quantitative and qualitative screens, KPMG was left with a set of nine comparables, each of which was a distributor. The nine companies and a brief description of their business activities are as follows:

a. **Advanced Marketing Services, Inc.**

Advanced Marketing was engaged in distributing and packaging general interest books to membership warehouse clubs and office product superstores and other specialty retailers, operating four distribution centers in the United States. Also, Advanced Marketing published a limited number of titles through its in-house publishing arm. The company provided product selection advice, merchandising, packaging, product development services, distribution and handling services and in-store management of certain customers' book departments through its independent service representatives. It introduced a Vendor Managed Inventory replenishment system to reduce the need to write individual location orders and to improve inventory turnover. It developed software to forecast future book sales based on the life expectancy of particular titles. The Vendor Managed Inventory replenishment system was used to prepare store level orders for Advanced Marketing’s two largest customers in the latter part of 1997. In March 2000, the company had 561 full-time employees and additional unspecified part-time employees who were hired primarily during peak holiday periods.

b. **Amcon Distributing Co.**

Amcon distributed a wide variety of consumer products, including cigarettes and tobacco products, candy and other confectionery, beer, soft drinks and other beverages, groceries, natural foods and health and beauty products from seven distribution centers. Amcon also markets its own private label candy under a manufacturing agreement with a third party. It served the Great Plains and the Rocky Mountain region. Amcon offers planograms (store layout planning tools) to its convenience store customers to assist in the design of their stores and display of products within the stores and internet-based customer maintenance and reporting. Amcon maintains eight distribution centers in the United States, which included the distribution center of FFH, a health food distributor it acquired in November of 1997. Because it distributes products regulated by the government, it incurs additional costs of compliance. As of September 30, 1999, Amcon had 1,017 full-time and part-time employees.

c. **Celebrity Inc.**

Celebrity was one of the largest distributors of artificial flowers, foliage and flowering bushes, selling to mass market retailers, craft store chains, other retailers and wholesale florists. Celebrity’s sales force assisted customers in devising market strategies, planograms and merchandising concepts as well as offering advice on advertising, product promotion and store displays. Celebrity offered over 14,000 products to approximately 2,000 customers both domestically and abroad and contributed to their design. Celebrity coordinated the just-in-time delivery requirements of many customers, especially the mass marketers, which needed to minimize inventory costs while assuring full product availability. To assist in this endeavor it utilized electronic data exchange for the placement of orders. As of August 31, 1999, the company had 551 full-time and part-time employees. The company works with about 70 manufacturers but purchases most of its products from only 12. Since it is the predominant customer of these suppliers, Celebrity believed it received superior pricing and service. The company competes on the basis of customer service, product quality, supply dependability, product line breadth, price and brand name recognition. Celebrity has registered many trademarks in conjunction with its products in the United States which it believed had significant value in the marketing of its products and services and protects them vigorously against infringement. The company faced significant risk from its operations in Asia, including fluctuations in trade regulation, economic instability in the Far East and currency fluctuations.

d. **Color Spot Nurseries, Inc.**

Color Spot, one of the largest wholesale nurseries in the United States, sold high quality plants to retailers and provided extensive merchandising services and sales and inventory planning to leading home centers, mass merchants and premium independent garden centers. The company provided its customers with a broad array of value-added services, such as in-store merchandising, product display and maintenance, promotional planning and product reordering, including sales and inventory planning, all of which it believed were valuable in differentiating it from its competitors. Its merchandising services also included the design and construction of display tables and end caps, as well as reordering and restocking services. The company was the owner of the trademark "COLOR SPOT" in the United States under which the majority of its products were sold. As of September 1999, the company had 2,500 full-time employees and over 4,200 employees during peak growing season, February through June.

e. **Daisytek International Corporation.**

Daisytek was a wholesale distributor of computer, copier, fax and office supplies products, professional audio and video tape products and was also a leading provider of transaction management services to both traditional and electronic commerce companies. The company operated in three business segments: computer and office supplies; professional tape products; and transaction management services. Each segment offered different products and services and was managed separately. The computer and office supplies segment distributed over 10,000 products to over 30,000 customer locations, including value-added resellers, computer supplies dealers, office product dealers, contract stationers, office product superstores and other retailers who resold to end users. Computer supplies revenues for the fiscal year ended March 31, 2000 represented 89.5% of total revenue for the period. In this segment, the company used sophisticated telemarketing, direct mail programs, innovative sales promotions, and electronic commerce technology to market its product. Daisytek's professional tape products segment was a distributor of media products to the film, entertainment and multimedia industries, distributing more than 3,000 products to over 26,000 customers. Customers included production and post production companies, educational institutions, broadcast stations and others. Revenues from this segment represented 8.8% of total revenues for the fiscal year ended March 31, 2000. The company's third segment, transaction management services, provided business infrastructure solutions for manufacturers, distributors and retailers which included order management, web-enabled customer care, billing and collection services, information management, international fulfillment and distribution services and professional consulting. Customers were able to place orders directly into Daisytek's order processing system. In addition, the company provided extensive retail training for its computer supplies products sales personnel. Daisytek operated distribution centers in the United States, Canada and Mexico. As of March 31, 2000, the company had about 1,676 full and part-time employees in the United States and abroad.

f. **Di Giorgio Corporation.**

Di Giorgio was an independent wholesale distributor of grocery, frozen and refrigerated food products that supplies about 17,300 products to more than 1,700 supermarkets (independent and chain stores). The company also sells its own line of "White Rose" products that are made by third-party manufacturers and comprise about 4% of sales. The company developed and distributed an internet product, "EasyGrocer.com," to retail supermarkets which allowed customers to order from a local supermarket's entire inventory for either delivery or pick-up. Di Giorgio maintained three large distribution centers in the New York Metropolitan area from which it serviced its customers. The company also provided retail support services, including advertising, promotional and merchandising assistance, retail operations counseling, computerized ordering, insurance, coupon redemption, store layout, equipment planning, store engineering, sanitation and security services. The company sent retail counselors to stores on a regular basis to represent the company and to advise store management regarding operations. Most customers utilize computerized order entry, which enabled them to place orders 24 hours a day, 7 days a week. Di Giorgio owned trade names and trademarks which it believed gave it a competitive advantage. Two trade names, Met and Pioneer, are owned by the company but used by independent customers. It enabled smaller retailers to gain the advantages of merchandising and advertising of much larger stores. In exchange, these customers were obligated to purchase most of their product from Di Giorgio. As of January 1999, the company employed approximately 1,275 people.

g. **Globenet International I Inc.**

In October 1999, Globenet changed its name to Royal Bodycare, Inc. The company marketed various personal care products, including herbs, vitamins and minerals, as well as natural skin, hair and body products. All the products are marketed under the Royal Bodycare trade name and are purchased from unaffiliated suppliers and manufacturers, which make or process the products in accordance with the company's specifications. The company employed about 138 employees in 1999. The company rents office and warehouse space of 119,000 square feet. The product was marketed through 132,000 independent distributors, of which 112,000 were located in the United States. These individuals used a direct marketing approach to end users, explaining the products and demonstrating their use and application. The internet was used to enhance communication with distributors about new products, specials and promotions.

h. **J B Williams Holdings, Inc.**

J B Williams was a holding company with subsidiaries which marketed, sold and distributed personal and healthcare products through a network of independent brokers to retailers. Products distributed included men's grooming products, shampoos and conditioners, pre-shave lotions, shaving soap, mouthwash, throat spray and lozenges, and cold sore and fever blister medication. Walmart accounted for 17% of the company's sales. The company's products were manufactured by outside third parties, although J B Williams held the trademarks for products such as Aqua Velva, Lectric Shave and Cepacol, among others, which it considered to be its most valuable assets. The company had 49 employees and maintained its executive offices in Glen Rock, NJ, while using public warehouses and distribution facilities in Indiana and Nevada.

I. **U S A Floral Products, Inc.**

U S A Floral Products was a wholesale distributor of perishable floral products, including freshly cut flowers, greens and potted plants and floral-related hardgoods like vases, glassware, foam for flower arranging, tools and other supplies. The company had the largest integrated distribution system of floral products in the world, with hundreds of sources of supply and more points of distribution than any of its competitors, giving it an advantage in serving mass-market retailers and significant buying power with growers and suppliers of hardgoods. The company's size also allowed it to realize savings on transportation and handling costs. In addition, it provided pre-packaged floral bouquets and arrangements to retailers. It provided marketing materials and its personnel maintained floral displays for mass market retailers and helped to prepare specific arrangements to meet customer needs. It also offered Internet-based services to its customers. Floral provided higher value-added services to customers including bouquet and arrangement making, product branding, marketing support to retailers and freshness dating. Customers included retail florists, supermarkets, mass-market retailers, catalog retailers and Internet retailers, as well as wholesale distributors and arrangement and bouquet makers. The company did not operate growing operations or retail florists. As of March 2000 the company had approximately 3,700 employees.

47. Generally, the comparable profits method must utilize the data from a three-year period of comparability, which includes the taxable year under review and the preceding two years. In the instant matter, 1999 data was not fully available for the comparables because of differing fiscal years, and KPMG was forced to rely on data from the period 1996 through 1998. However, KPMG included in its report an analysis of 1999 using Marketing's data.

48. KPMG made several specific adjustments in an attempt to improve comparability between Marketing, the tested party, and the comparable firms identified above. These adjustments addressed the differences in payment terms for sales and purchases, the differences in inventory holding and accounting for the function of manufacturing of fixtures.

49. The purchase and sale of product under delayed payment terms entails the purchase or sale price and a loan for the same amount, and a price which includes an interest charge. Firms account for this in various ways and the results may affect the level of sales revenue and cost of sales and distort profitability comparisons. KPMG made adjustments to the Berry ratios of the comparables by subtracting an adjustment factor from sales (gross profit) and cost of sales of each comparable.

50. Because Marketing held no inventory and most distributors do, it was necessary for KPMG to make an adjustment to the comparable distributor's data for inventory level differences, where the differences reflect a difference in services that the comparable offers to its customers or takes on from its suppliers. The underlying theory was that holding inventory is

costly and independent distributors providing the service required greater compensation from customers and suppliers, thus warranting an adjustment.

51. To account for the difference in inventory holding services, KPMG adjusted the gross profits of the comparables to consider the interest expense on the difference in the inventories between Marketing and the comparables.

52. Based on these two adjustments KPMG created a table of the interquartile range of the Berry ratios of the nine comparable distributors and found that for the three-year period 1996 through 1998 Marketing's Berry ratio fell within the interquartile range for two of the three years and within the range for the three-year average. The table below reflects the Berry ratios for the narrow set of comparables as adjusted for accounts receivable, accounts payable and inventory.

	1996	1997	1998	Weighted Avg. 1996-1998
25th Percentile	1.10	0.93	1.14	1.00
50th Percentile	1.25	1.12	1.16	1.16
75th Percentile	1.26	1.22	1.18	1.20
Marketing	1.11	1.09	1.09	1.10

A second table was prepared for the larger set of distributors and it was demonstrated that Marketing's Berry ratio was within the interquartile range for two of the three years and also within the average for the three-year period. The following table reflects the Berry ratios for the broader set of 101 comparables as adjusted for accounts receivable, accounts payable and inventory.

	1996	1997	1998	Weighted Avg. 1996-1998

25th Percentile	1.09	1.09	1.10	1.09
50th Percentile	1.17	1.20	1.20	1.20
75th Percentile	1.32	1.34	1.33	1.34
Marketing	1.11	1.09	1.09	1.10

53. Dr. Brian J. Cody also prepared an analysis of Marketing's intercompany pricing and the derivative analyses. Dr. Cody had 17 years of experience in government economic studies and transfer pricing while working closely with many companies in various industries. He was a senior economist with the Federal Reserve Bank of Philadelphia, a transfer pricing manager at Coopers and Lybrand and a partner in the intercompany transfer pricing group of Arthur Anderson. As of the hearing date, Dr. Cody was a vice president of InteCap, Inc., a subsidiary of Charles River Associates Inc. He used his knowledge to negotiate unilateral and multilateral advance pricing agreements and consulted on intercompany pricing structures. In addition, Dr. Cody is a published author and distinguished speaker on the subject of transfer pricing. He was accepted as an expert in transfer pricing.

54. An update was performed by Dr. Cody which utilized the 1999 financial data for Marketing and the nine comparable companies for the period corresponding to Marketing's 1999 fiscal year.[1] The following tables set forth the Berry ratios reflecting the 1999 data as prepared by Dr. Cody.

Comparable Cos.	**3 yr. Wt. Avg.**	**1999**	**1998**	**1997**
Advanced Marketing	1.395	1.427	1.406	1.318
Amcon	1.083	1.280	0.873	1.117

[1]Dr. Cody used data acquired from the Compustat database which he confirmed (with Compustat) used restated financial data which insured that acquisitions, dispositions, and other material changes were captured and presented to give a consistent view of income statements and history within the company.

Celebrity	1.011	1.069	1.147	0.838
Color Spot	0.999	1.082	1.166	0.715
Daisytek	1.254	1.047	1.401	1.417
Di Giorgio	1.797	1.971	1.683	1.715
Globenet	1.014	1.027	1.029	0.938
JB Williams	1.190	1.241	1.158	1.157
U S A Floral	1.098	1.059	1.173	0.988
Statistical Analysis	3 Yr. Wt. Avg.	1999	1998	1997
Maximum	1.797	1.971	1.683	1.715
Upper Quartile	1.254	1.280	1.401	1.318
Median	1.098	1.082	1.166	1.117
Lower Quartile	1.014	1.059	1.147	0.938
Minimum	0.999	1.027	0.873	0.715
Marketing	1.103	1.130	1.088	1.091

55. As stated above, Marketing manufactured store display fixtures that were provided to customers, which presented a functional difference with many of the distributor comparables, most of which did little manufacturing. However, KPMG minimized the effect of this function, stating that operating expenses associated with fixture manufacturing were only $14.9 million per year over the period while total operating expenses for Marketing as a whole were $353.6 million and that the Berry ratio implicitly adjusted for the difference in function by recognizing a return on the manufacturing function.

KPMG separately analyzed the manufacturing function and its effect on the “Berry” ratio. The Berry ratio is often applied to a distributor whose cost of sales consists chiefly of the cost of purchasing goods that are then resold. KPMG derived a set of comparable manufacturing companies and calculated the return on assets for them, and then determined that an arm's-length return for Marketing's manufacturing function was the median return on assets of the selected manufacturing companies. KPMG then made an adjustment to the "Berry" ratio for the nine selected comparables to assume that each of the distribution comparables engaged in manufacturing to the same extent as Marketing. KPMG determined that Marketing still fell within the interquartile range of the comparables. KPMG concluded that this adjustment demonstrated that Marketing's manufacturing activities did not affect the results of its IRC § 482 analysis, a conclusion confirmed by Dr. Brian Cody, who found that KPMG's manufacturing adjustment did not materially affect the KPMG report and its conclusions.

56. As stated in Findings of Fact "27" through "30," Marketing entered an Agreement on February 16, 1999 whereby it agreed to sell its receivables to HFC. HFC agreed to assume all bad debt and returns risks and the cost of holding the receivables until payment, two factors which justified a discount on the purchase price for the receivables. A decision was made to account for losses due to returns and allowances in the numerator, or gross profits, of the Berry ratio. This was done to accurately reflect the set off against sales in arriving at the net sales amount. The theory was that not accounting for the returns and allowances would have resulted in a higher numerator, a larger Berry ratio and a distorted placement of Marketing in the interquartile range. This was a significant consideration for KPMG because Marketing's sale of its receivables significantly reduced its 1999 average monthly receivables balance.

57. After making the adjustments for accounts receivable, accounts payable and inventory for the set of comparables using the 1996 through 1998 data, and Marketing's 1999 data, KPMG calculated the Berry ratios for each and established an interquartile range of .96 to 1.16.

Marketing's Berry ratio, 1.13, was within the arm's-length range of profitability of comparable uncontrolled parties. Cards used the range to make year-end adjustments to Marketing's books, which resulted in Marketing paying Cards 79.8% of the suggested wholesale price net of discounts, allowances and returns for products in the year 1999.

58. To determine if the Berry ratio was a reasonable PLI to utilize in applying the comparable profits methodology, Charles River Associates Inc. tested two alternative PLI's which are also used when applying the comparable profits methodology to companies like Marketing. The two PLI's used were the return on sales (operating profit expressed as a percentage of net sales) and the return on operating assets (operating profit expressed as a percentage of operating assets). These particular PLI's were commonly used to test the reasonableness of intercompany pricing policies between a manufacturer and its related party reseller and they were considered less sensitive to the classification of expenses as operating expenses or costs of goods sold than the Berry ratio. The return on assets was also less sensitive to functional differences between the tested party and the functionally comparable companies than other PLI's.

59. The return on sales analysis indicated that Marketing's average return on sales was within the interquartile range for the three-year period 1997 through 1999 established by the largest and smallest return on sales percentages of the comparable companies. In addition, Marketing's return on sales percentage for the year 1999 was within the interquartile range as established by the nine comparables. Below is a tabulation of that data as generated by Charles River Associates Inc.

Comparables	3 Yr. Wt. Avg.	1999	1998	1997
Adv. Marketing	3.5%	3.9%	3.6%	2.5%
Amcon Dist.	0.8	2.1	-1.2	1.4
Celebrity Inc.	0.2	1.5	3.1	-3.8
Color Spot	0.2	2.5	5.9	-10.3
Daisytek	2.4	0.6	3.4	3.1
Di Giorgio	2.0	2.3	1.6	1.9
Globenet	0.4	0.9	1.9	-4.6
JB Williams	9.2	11.2	7.8	8.4
U S A Floral	2.3	1.4	4.1	-0.3
Statistical	**Analysis**			
Maximum	9.2%	11.2%	7.8%	8.4%
Upper Quartile	2.4	2.5	4.1	2.5
Median	2.0	2.1	3.4	1.4
Lower Quartile	0.4	1.4	1.9	-3.8
Minimum	-0.2	0.6	-1.2	-10.3
Marketing	1.8%	2.2%	1.5%	1.6%

60. The return on assets analysis demonstrated that Marketing's average return on assets fell within the interquartile range for the three-year period 1997 through 1999 as well as for the year 1999. The following tables reflect the outcomes of the analysis performed by Charles River Associates Inc.

Comparables	3 Yr. Wt. Avg.	1999	1998	1997
Adv. Marketing	9.7%	11.3%	9.5%	7.5%
Amcon Dist.	6.4	13.4	-9.1	10.6
Celebrity Inc.	1.7	4.5	8.3	-6.2

Color Spot	0.7	2.4	5.5	-11.6
Daisytek	9.4	3.2	13.2	14.4
Di Giorgio	9.0	11.7	7.4	7.4
Globenet	0.7	3.0	7.1	11.2
JB Williams	7.4	9.7	6.5	5.6
U S A Floral	3.0	1.4	6.9	-1.3
Statistical	**Analysis**			
Maximum	9.7%	13.4%	13.2%	14.4%
Upper Quartile	9.0	11.3	8.3	7.5
Median	6.4	4.5	7.1	5.6
Lower Quartile	1.7	3.0	6.5	-6.2
Minimum	0.7	1.4	-9.1	-11.6
Marketing	3.6%	4.7%	3.0%	3.1%

61. The Division introduced Dr. Alan C. Shapiro who was accepted as an expert in transfer pricing, economics, corporate finance and the valuation of intangibles. Dr. Shapiro taught at the Wharton School, University of Pennsylvania and, from 1981 to present, at the Marshall School of Business, University of Southern California. He has written two books on multinational financial management since 2003 and several others on corporate finance. In addition, he has published numerous articles on a variety of subjects and presented executive programs at universities and corporations in areas from global macroeconomics to international financial management.

62. Dr. Shapiro analyzed the original KPMG report upon which the transfer price was established herein, in addition to the reports of Dr. Cody, and came to the conclusion that the analysis was fatally flawed because KPMG had determined that Hallmark Marketing was a

"mere" distributor which possessed no valuable intangible assets. Dr. Shapiro believed that Marketing had many valuable intangibles, including: a well-trained sales force; expertise in site and owner selection and real estate negotiations; participation in design, development and manufacturing of display fixtures; engagement in trade name protection services; provision of sophisticated management tools to retailers; creation of a business-to-business website; ownership of Hallmark stores; development of a customer loyalty card program; and most importantly, development and possession of a unique and valuable distribution channel granted to it by Cards. Dr. Shapiro reasoned that KPMG's assumption, that Marketing had no valuable intangibles, poisoned the selection of comparables and the interquartile distribution.

63. Dr. Shapiro devoted a significant portion of his expert report to brand equity and its positive effect on profit margin which results from price premiums charged for product. Greater brand equity produced a greater market share and a larger number of loyal customers allowing for price premiums. Greater brand equity also translated to lower marketing costs and a distinct competitive edge in the marketplace and greater revenue opportunities.

The value of retail equity was also analyzed by Dr. Shapiro. He stated that it was derived through meeting relevant customer expectations and developed through the decentralized actions of each store. It was heavily dependent on market positioning and market mix, the latter comprised of location, store design and display and customer service. Dr. Shapiro opined that Marketing's expertise in operations and supply chain management was critical to its success in developing a loyal customer base and building retail equity.

64. Dr. Shapiro reasoned that, since Marketing had the right to sublicense under the Distribution Agreement with Cards and only the owner of brand elements could license or lease

them, Marketing was more than a "mere" independent distributor of product. Dr. Shapiro stated that an independent distributor would only be interested in economic benefits, not its relationship to Cards. Further, Dr. Shapiro believed an independent distributor would not have agreed to the inherent constraints on resale prices while simultaneously being deprived of enjoying the brand value benefits it would have obtained if it truly had been an "independent" distributor.

65. Dr. Shapiro noted that the KPMG report minimized the advertising and manufacturing aspects of Marketing's business saying that Marketing did not pay for advertising which generated brand value and did not own or have a beneficial right to any valuable trademarks or trade names. However, Dr. Shapiro downplayed the importance of manufacturing and trademark and trade name ownership, saying that the more emotional or highly involved the product and the brand choice decision, the more important are factors which create the brand's intangible value. He argued that Marketing's input to forecasting and merchandising to local levels was far more important to securing brand preference and loyalty. He noted the manipulation of store atmospheres through displays and designs as prime examples of contributors to brand equity, in addition to customer service, supply chain management and location of stores.

66. Dr. Shapiro underscored the importance of Marketing's role in selecting new owners for Hallmark stores, whereby it helped to create a network of hand-selected entrepreneurs committed to selling Hallmark products. In this way, Marketing was able to have a significant effect on the quality of retail customer service and on the value of the Hallmark brand.

67. In addition, Dr. Shapiro observed that Marketing contributed to brand value by testing new ideas in the stores he alleged Marketing owned through its subsidiary, Hallmark Specialty Retail Group. One example given by Dr. Shapiro was the five years of testing that was done for

“Showcase” stores: stores twice the size of regular Hallmark stores with a focus on home decor and gifts. The test was performed in “Creations” stores, which Dr. Shapiro said were owned by Marketing.

68. Dr. Shapiro concluded that, although Cards may have created brand awareness and familiarity, it was Marketing’s assistance to retailers that created brand loyalty, and therefore the majority of brand equity creation and maintenance must be attributed to Marketing’s efforts. Without specifying the amount or directing how to value its efforts, Dr. Shapiro stated that any compensation for Marketing’s efforts must be based on more than the dollar cost of its efforts. In addition, although Cards may have had brand ownership, it was Marketing that used the brand and derived the benefit from its intangible value. In Dr. Shapiro’s view, the right to use the brand and the right to exploit the brand’s intangible value were inseparable and Marketing’s activities clearly enhanced the value of the brand. However, given the very restrictive contractual relationship it had with Cards, it did not derive any residual claims from intangible brand value creation.

69. In concluding his remarks on Marketing’s enhancement of brand equity, Dr. Shapiro stated that the intangible value of the brand assets was such that the ownership rights cannot be separated from the right to use them, and the right to use them cannot be separated from the right to exploit the intangible value of those assets. Without any comment on the calculation of an appropriate transfer price, Dr. Shapiro noted that any transfer price which tries to separate these rights must entail an analysis beyond the simple assignment of brand assets or the split of current profits from business transactions.

70. The second half of Dr. Shapiro's report addresses itself to the KPMG report and the methodology used therein. It was Dr. Shapiro's conclusion that every step of KPMG's analysis was based on incorrect assumptions or contained conceptual errors. As evident from his analysis reviewed above, KPMG's assumption that Marketing held no valuable intangibles was a critical and fatal flaw.

71. Dr. Shapiro listed what he believed to be KPMG's core contentions and disagreed based on his belief that Marketing did have valuable intangibles and, by ignoring them, KPMG placed a bias on its estimate of Marketing's return on its activities. The core contentions which Dr. Shapiro identified and discussed in great depth in the first part of his report were that brand assets could be separated; that intangible brand value is derived from manufacturing and advertising only; that marketing activities and local programs could be compensated on the basis of their costs and not their impact; and that all residual claims from brand equity belong to the brand asset owner.

72. In Dr. Shapiro's view, KPMG's selection of the comparable profits method was consistent with its erroneous assumption that Marketing owned no valuable intangibles because it contemplates that the companies compared have no valuable intangibles. With respect to KPMG's selection of the Berry ratio as the PLI, Dr. Shapiro noted that it was only a proper PLI for a very restricted class of distributors and should not have been used where a firm combined distribution with other functions. Therefore, it was an inappropriate PLI in this matter.

73. With respect to the comparables chosen by KPMG, Dr. Shapiro believed that the failure to acknowledge that Marketing had valuable intangibles poisoned the selection process. The KPMG quantitative screens applied to the 207 original comparables eliminated companies

based on R&D expenses, advertising expenses, years of financial data and those with sales of less than 20 million dollars. These screens essentially eliminate companies with valuable intangibles like those Dr. Shapiro believed Marketing possessed. Therefore, the chosen comparables were not “comparable” to Marketing.

74. Dr. Shapiro commented that the adjustments to accounts receivable, accounts payable and inventory made to the Berry ratios of the comparables may have been appropriate to improve the comparability between the tested party and the comparables, but he disagreed with the interest charge applied by KPMG to the inventory because it expressed the adjustment to inventory in nominal rather than present value terms, which he believed lowered the Berry ratios of the comparables.

75. Dr. Shapiro determined that KPMG miscalculated the Berry ratio of Marketing by not including depreciation in the denominator of the formula Gross Sales/Operating Expenses + Depreciation, thus inflating Marketing’s Berry ratio in comparison to the comparables, which did include depreciation in the denominator.

76. Dr. Shapiro also noted that the adjustment made by KPMG for the sale of accounts receivable to HFC in 1999 had the effect of creating a larger adjustment for accounts receivable for all of the comparables than if it had utilized the 1996-1998 Marketing accounts receivable data. This use of the lower accounts receivable figure for 1999 resulted in a lower interquartile range for the nine comparables.

77. Without conceding that the KPMG report was not fatally flawed because it ignored valuable intangibles and considered Marketing a straightforward distributor, Dr. Shapiro made some adjustments of his own to illustrate that KPMG biased its results in making its adjustments.

He changed the quantitative screen that eliminated companies with sales less than $20 million and increased that threshold to $500 million, a figure he said produced companies with a similar scale of operations. He also corrected misstatements of depreciation for several of the comparable companies, using data he found in the Forms 10-K. Dr. Shapiro also eliminated the use of 1999 data for accounts receivable and substituted the interest rate ratio for the inventory adjustment. He also subtracted depreciation from the denominator of the Berry ratio for each of the comparables to be consistent with KPMG's calculation of the Berry ratio of Marketing.

78. After making these adjustments, Dr. Shapiro determined that Marketing's Berry ratio of 1.10 fell outside the interquartile range for the entire KPMG data set, its broad list of comparables and its narrow list. Dr. Shapiro set forth the following chart to summarize the results of his adjustments.

KPMG Data Set	Interquartile Range 96-98 Berry ratios before Corrections	Interquartile Range 96-98 Berry ratios after Corrections
All Companies	1.06 to 1.28	1.16 to 1.48
Broad List	1.06 to 1.25	1.16 to 1.43
Narrow List	1.02 to 1.19	1.13 to 1.36

79. The Division's second expert witness was Dr. Ednaldo Silva, who was accepted as an expert in economics and transfer pricing, particularly in the area of the Internal Revenue Code § 482 regulations. Dr. Silva, who earned a masters degree and Ph.D. in economics from the University of California at Berkeley, worked with the Internal Revenue Service in New York beginning in 1989 and one year later took a position with the Office of the Chief Counsel of the IRS in Washington, D.C., where he worked on the advanced pricing agreement program. He

remained there for three years and then left to become the chief economist for the law firm of Sherman and Sterling, where he worked until 2001 when he opened his own business, RoyaltyStat LLC, which managed a database of license agreements. He has taught economics, statistics and econometrics for over ten years at the University of California at Berkeley and the New School for Social Research. He participated in the drafting of the regulations promulgated under IRC § 482 in 1993 (on the temporary regulations) and in 1994 (on the final regulations). Dr. Silva also has published numerous articles on transfer pricing.

80. Dr. Silva created a report which evaluated the arm's-length nature of intercompany transactions between Cards and Marketing in 1999 with particular attention to the provisions of Internal Revenue Code § 482 and the regulations thereunder. Dr. Silva observed that approximately 75% of Marketing's operating expenses came from intercompany transactions. Dr. Silva described the "best method" rule for finding the most reliable measure of arm's-length transactions, the standards of comparability for determining the degree of comparability between controlled and uncontrolled transactions, transfer pricing methods for tangible goods and intangibles and the consideration which should be given for the provision of intercompany services.

81. Dr. Silva determined that the KPMG report was flawed for numerous reasons. He said KPMG's report focused on Marketing's distribution activities and purchases from Cards, while failing to address other critical intercompany transactions. Dr. Silva believed the most egregious omission was the sale by Cards to Marketing of raw materials used in the production of display fixtures at a 95% discount. The net result of such sales was the distortion of Marketing's cost of goods sold with the possibility of further distortion if the display fixtures loaned to customers

were amortized in operating expenses. Dr. Silva believed that if the purchase price of materials were arm's length, the cost of goods sold would be higher and the gross profit lower, decreasing Marketing's Berry ratio. Hence, Dr. Silva concluded that the Berry ratio was unreliable as calculated by KPMG.

82. Dr. Silva criticized the KPMG report for not addressing the provision of general and administrative services to Marketing by Cards which was noted in the audited financial statements of Marketing as charged at actual cost. Dr. Silva noted that such charges, if at arm's length, should have included a profit and a recovery of all costs associated with the provision of the services. According to Dr. Silva, Cards charged only 35 million dollars to Marketing in 1999 but actual expenses were 49 million dollars. The result of this undercharge for general and administrative services was a higher, and distorted, Berry ratio. However, it is noted that the audited financials for Marketing for 1999 do not include the figures used by Dr. Silva. His information was taken from electronic mail from a Hallmark employee, Buffy Walker, to Cards' Tax Manager, Mark Shaefer, on March 15, 2004.

The 1999 audited financial statement indicated that Cards paid general and administrative costs of $233,000,000.00, which were charged to Marketing at cost. In addition, Cards charged Marketing an administrative fee of $39,900,000.00.

83. Dr. Silva observed that the license agreement between Cards and Marketing, dated October 1, 1999, granted Marketing the use of valuable trademarks and tradenames without royalty charge. Further, Marketing did not charge retailers to whom it sublicensed the trade names and trademarks. It was Dr. Silva's position that under uncontrolled circumstances, a distributor would pay for the right to use and sublicense the trademarks and trade names. Thus,

the absence of such an expense caused Marketing's operating expenses to be understated and the resulting Berry ratio to be higher and unreliable.

84. Dr. Silva noted that Marketing engaged in activities to protect the trademarks, including having its salesmen inspect retail premises to monitor use of said marks and names. Such intercompany services should have been considered and valued and Marketing compensated for its services. Dr. Silva stated that KPMG never addressed this issue in its report.

85. Another intercompany transaction which Dr. Silva said KPMG failed to accurately account for was the development of the Retail Operating Model ("ROM") which was a computerized system for inventory management, performance reporting, e-mail and warehousing support. The roll-out of this product had been estimated to cost $50 million, shared by Cards and Marketing. However, since the system addressed areas within the scope of Cards' business, Dr. Silva concluded that Marketing's share of the development cost should have been compensated by Cards for its services or Marketing granted ownership rights, in which case Marketing would have owned an intangible.

86. Another weakness cited by Dr. Silva was the loss incurred on the sale of receivables to HFC in 1999 and KPMG's failure to address the issues raised thereby. The first was KPMG's treatment of the loss as an addition to cost of goods sold rather than as an operating expense. Dr. Silva pointed out that internal documents indicated that the loss was properly an operating expense, but accounted for in cost of goods sold, the former of which would have resulted in a lower Berry ratio. Dr. Silva claimed there was no authority for including the loss in cost of goods sold, and the recharacterization of the loss was done for purposes of transfer pricing only.

In addition, Dr. Silva noted that KPMG did not analyze the arm's-length character of the sale of the receivables nor did it consider the sale when it selected comparables and whether it created a functional difference between Marketing and the selected companies. Dr. Silva also questioned whether KPMG made an adjustment to Marketing's accounts receivable for 1999 to correspond to the adjustment to cost of goods sold, to avoid double counting, since the lower level of accounts receivable after the sale of receivables caused a downward shift in the interquartile range when KPMG performed its asset adjustments.

87. Dr. Silva determined that KPMG erred in selecting the comparable profits method. He concluded that KPMG failed to do an accurate functional analysis of Marketing, the tested party, leading to the selection of improper comparables and the wrong PLI.

88. With regard to the functional analysis, like Dr. Shapiro, Dr. Silva criticized KPMG for its characterization of Marketing as a straightforward distributor. It was noted that Marketing held no inventory, performed manufacturing functions and provided real estate, business brokerage and trademark protection services. In addition, Dr. Silva observed that Marketing had a large market share and established distribution channels and also developed intangibles like ROM and MIX, a business-to-business website.[2] In addition, it was noted that there was some overlapping of personnel between Marketing and Cards producing an integration which generated synergies that were not taken into account by KPMG. Dr. Silva argued that not taking these functions into account poisoned all attempts to locate comparable companies and doomed the KPMG report to failure.

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[2]MIX (Marketplace Information Exchange) Inc. was a business-to-business website, which Marketing helped to develop but was operated by a separate legal entity that enabled retailers to order products on-line.

89. Dr. Silva said the two greatest mistakes were categorizing Marketing as a straightforward distributor which did not possess valuable intangibles and choosing comparables that were not straightforward distributors. He also noted problems with each of the comparables that he believed demonstrated they were not straightforward distributors:

a) Advanced Marketing published books and operated retail outlets;

b) Amcon sold its own brand of products and owned the trademarks related to them;

c) Celebrity designed and produced its own artificial floral products;

d) Color Spot Nurseries engaged in agricultural production, producing the property it sold;

e) Di Giorgio sold products under its own name, operated a retail grocery delivery website and operated only in the New York metropolitan area;

f) Globenet sold its products to independent distributors on what it described as a multi-level distribution network and reported only two years of operating results;

g) JB Williams produced its own products, owned valuable trademarks and relied on third parties to perform the distribution function;

h) U S A Floral Products was a start-up company with less than two years of operation.

Dr. Silva, from his own investigation of the comparables from public records, determined that all except Daisytek owned registered intangibles while KPMG never stated that Marketing owned any.

90. Dr. Silva rejected KPMG's selection of the Berry ratio as the PLI in its application of the comparable profits method. He believed that the contaminated intercompany sales between Marketing and Cards which did not reflect an arm's-length charge for materials, general and administrative services and use of trademarks should have eliminated the Berry ratio as a PLI.

In addition, Dr. Silva claimed that KPMG overlooked differences in accounting methods between Marketing and the comparables selected with specific reference to the composition of operating expenses. Without consistency in accounting for operating expenses the use of the Berry ratio was in error. Dr. Silva also noted that the use of the Berry ratio is not appropriate when comparing companies that mix distribution and manufacturing activities.

91. Dr. Silva observed that the Berry ratios derived for the nine comparables were based on different accounting methods. He concluded that the allocation of depreciation and amortization to cost of goods sold and operating expenses was not performed consistently by the nine companies, and therefore, the resulting computation of the Berry ratios was tainted.

92. Dr. Silva disagreed with the asset adjustments made by KPMG to equalize the differences between Marketing and the comparables. On a conceptual basis, he believed that since the level of current assets maintained by a company is correlated to sales, any adjustment of current assets must show that there is no such correlation. In the alternative, Dr. Silva argued that adjustments to inventory, accounts receivable and accounts payable were in error, contaminated by KPMG's failure to accurately reflect transfer prices for fixture materials, general and administrative services and other intercompany transactions mentioned above.

93. Dr. Silva pointed out the interquartile range established by KPMG included a value which was below zero, indicating operating expenses greater than gross profit. He noted that this was incongruous with the economic reality that a firm operating at arm's length would not enter into transactions that produce operating losses.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge observed that under prior decisions of the Tax Appeals Tribunal the presumption of distortion set forth in the regulations can be rebutted by the taxpayer by showing that the transactions between the corporations were at arm's length and that the principles of section 482 of the Internal Revenue Code provide appropriate standards for making that determination. He then reviewed the Treasury Regulations under section 482 and concluded, based on "the sound and thoroughly prepared report of KPMG," that Marketing demonstrated that its intercompany pricing with Cards was at arm's length and accordingly successfully rebutted the presumption of distortion. In making that determination, the Administrative Law Judge found that the contribution of Marketing to the enhancement of intangibles that benefitted Cards, the licensing of trademarks, and various ancillary services conducted by Marketing, including store design, real estate services, and trademark protection, were "ordinary distributor functions" that did not distinguish the functions of Marketing from those of comparable independent distributors. Also, manufacturing of store fixtures by Marketing was found to be merely *de minimis*.

ARGUMENTS ON EXCEPTION

The Division argues that the nine companies presented as comparable to Marketing in the KPMG report are not truly comparable to Marketing for several reasons. First, the companies are significantly smaller than Marketing. Second, the business functions of the companies are significantly different from those of Marketing. Third, Marketing owned valuable intangible assets that were not of the same kind or level as any of the intangible assets owned by those companies. Fourth, the KPMG report includes improper data and assumptions that disregarded different numbers of customers, different distribution channels, different size markets, different exposure to foreign markets, different product development activities and that included a start-up company and companies involved in significant manufacturing. Moreover, the Division asserts that Marketing was not compensated for significant services performed for Cards. In addition, the Division argues that petitioner's experts failed in numerous ways to follow the technical rules of the section 482 regulations. Finally, the Division argues that petitioner should be subject to the substantial understatement penalty.

Petitioner argues that the Administrative Law Judge correctly determined that there was no distortion that would require the forced combination of Cards with Marketing since Marketing rebutted the presumption of distortion set forth in the regulations and the Division did not meet its burden of establishing actual distortion. Petitioner submits that the KPMG study correctly applied the rules and principles of the section 482 regulations and that the Division's criticisms of the study are faulty. Petitioner asserts that since its reliance on the KPMG study was reasonable, there should in any event be no penalty. Finally, petitioner asserts that the forced combination of Cards with Marketing would violate the Due Process Clause and the Commerce Clause of the United States Constitution.

OPINION

Tax Law § 211.4 provides, in relevant part, as follows:

> (a) Combined reports permitted or required. In the discretion of the commissioner, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such

> information as the commissioner may require, subject to the provisions of paragraphs one through five of this subdivision.
>
> * * *
>
> (4) No combined report covering any corporation not a taxpayer shall be required unless the commissioner deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article.

Subdivision 5 refers to "any agreement, understanding or arrangement . . . between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected."

The regulations interpret this provision by providing that a group of corporations may be required or permitted to file a combined report where three conditions are met. First, the corporations must be related by direct or indirect stock ownership representing 80 percent of their voting stock (20 NYCRR 6-2.1[a][1], 6-2.2[a]). Second, the group of corporations must be engaged in a unitary business (20 NYCRR 6-2.1[a][2], 6-2.2[b]). Third, it must be found that reporting on a separate basis by a group of taxpayers distorts the activities, business, income or capital in New York State of the taxpayers. Such distortion will be presumed to exist if there are substantial intercorporate transactions among the corporations (20 NYCRR 6-2.1[a][3], 6-2.3[a]). In addition, the regulations provide that a foreign corporation not subject to tax will not be included in a combined report unless the inclusion "is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of . . . substantial intercorporate transactions . . . or some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected" (20 NYCRR 6-2.5[a]). In the present case the first and second test are met and the issue before us is whether the third test is also met.

While the words of section 6-2.5(a) standing alone might lend themselves to other interpretations, it is clear from the case law that it is necessary to find distortion, and not merely the existence of substantial intercorporate transactions, before combination of a taxpayer with a corporation not a taxpayer can be compelled. Thus, the Appellate Division stated in ***Matter of Standard Mfg. Co. v. State Tax Commn.*** (114 AD2d 138, 498 NYS2d 724, 726, ***affd*** 69 NY2d 635, 511 NYS2d 229) as follows:

> Having . . . concluded [that the stock ownership and unitary business tests were met], we turn next to the ultimate question of whether, under all of the circumstances of the intercompany relationship in this case, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income.

Similarly, in our later decision involving the same taxpayer we stated the following:

> In our view, [***Matter of Campbell Sales Co. v. State Tax Commn.***, 68 NY2d 617, 505 NYS2d 54, ***Matter of Wurlitzer Co. v. State Tax Commn.***, 35 NY2d 100, 358 NYS2d 762] and the Division's regulations support the conclusion that the existence of intercorporate transactions is sufficient to allow the Division to require filing on a combined basis; that the Division does not, as a "condition precedent" to such requirement, have to show that such transactions were unfair; *but that the taxpayer does have the opportunity to show that filing on a combined basis is not necessary to properly reflect tax liability* (emphasis added).
>
> * * *
>
> We find nothing in these opinions which indicates that the exercise of the Commissioner's discretion to require inclusion of a non-taxpayer in a combined report is not to be based on the rationale that such combination is necessary to properly reflect franchise tax liability. Neither do we find support for the conclusion that the existence of a unitary business relationship and substantial intercorporate transactions between a taxpayer and a non-taxpayer corporation creates, in effect, an irrebuttable presumption that a combined report is necessary

> in order properly to reflect tax liability. If that were the case, it would not have been necessary for the court in either case to make any statements that the requirement of combination was necessary to accurately reflect income (***Matter of Standard Manufacturing Co.***, Tax Appeals Tribunal, February 6, 1992).

We later concluded that the application of section 482 in an IRS audit could be relied upon in establishing arm's-length dealing between corporation and the accurate reflection of income (***see, Matter of USV Pharmaceutical Corp.***, Tax Appeals Tribunal, July 16, 1992) and that the Treasury Regulations under section 482 could be relied upon even in the absence of a Federal audit (***see, Matter of Medtronic, Inc.***, Tax Appeals Tribunal, September 23, 1993).

In a case like the present one where there are substantial intercompany transactions, a presumption of distortion applies which the taxpayer can rebut, as we stated in ***Matter of Silver King Broadcasting of N.J.*** (Tax Appeals Tribunal, May 9, 1996), by showing "that the intercorporate transactions which give rise to the presumption are arm's-length in order to prove that reporting on a separate basis is a proper reflection of income . . . . Where the taxpayer rebuts the presumption of distortion, . . . the Division, in order to require combination, must show why it believes that reporting on a separate basis does not properly reflect income."

The principal focus of this case is the KPMG study dated May 2000 (Exhibit E to Stipulation of Facts), which provides the following summary of its goals and results in the opening paragraphs as follows:

> KPMG LLP ("KPMG") was retained by Hallmark Cards, Inc. ("Cards") to recommend a range of transfer prices for the 1999 fiscal year for the related-party transactions between Cards and its wholly owned subsidiary Hallmark Marketing Corporation ("Marketing") [footnote omitted]. These transactions consisted largely of sales of tangible property from Cards to Marketing for resale by Marketing to unrelated retail stores. The property conveyed in these transactions was "social expression products"–primarily greeting cards–developed and produced by Cards.

> Given the set of data available we had to rely on comparable firm data appropriate for comparison with Hallmark data for the 1996-1998 period [footnote omitted]. This report, thus, first demonstrates that the results of the transfer prices charged in the transactions between Cards and Marketing for the period 1996-1998 were consistent with what one would expect to see at arm's length.
>
> We then used the same raw data for the comparable firms to estimate an appropriate arm's length range of profitability for Marketing for its 1999 fiscal year. To do this we made the standard adjustments to the comparable firm data to improve the comparability with Marketing, using relevant Marketing data for 1999. Specifically, we used Marketing's 1999 receivables, payables, inventory and sales data to make these adjustments. These results were then used to make final year-end adjustments to Hallmark's books.

The report applies the provisions of the Treasury Regulations and finds that the best method in the present case is the comparable profits method using as the profit level indicator the Berry ratio which is the ratio of gross profits to operating expenses. The report goes on in considerable detail to identify nine comparable companies through the application of various statistical "filters" to a large pool of companies in several databases and to apply various adjustments to the data of those nine companies to make the result more closely comparable. The principal author of the report, Dr. Ian E. Novos, testified at the hearing on direct examination (***see***, Hearing Tr., pp. 291-345), on cross examination (***see***, Hearing Tr., pp. 345-384), and on rebuttal (***see***, Hearing Tr., pp. 953-1017). Expert testimony of Dr. Brian J. Cody was presented on petitioner's behalf on direct examination (***see***, Hearing Tr., pp. 385-483), cross examination (***see***, Hearing Tr., pp. 483-518), and on rebuttal (***see***, Hearing Tr., pp. 1024-1085).

The Division makes various arguments in support of its exception. We address the most significant of those arguments below.

1. *The nine comparable companies are significantly smaller than Marketing* (Division's Brief in support, pp. 48-52). The Division argues that the five smallest of the nine companies should be thrown out of the sample. Leaving only the four largest would increase the average Berry ratio to which Marketing would be compared. In effect, the Division is asking to apply another "screen" to the data. The only justification for this is the statement that larger companies, like Marketing, enjoy economies of scale. While "economies of scale" is a familiar phrase, it is unclear whether such a condition is a distinguishing feature among these companies. There are no doubt large inefficient companies and small efficient companies. The record indicates that any such efficiencies were taken into account in preparing the KPMG report. Moreover, we assume that the goal of the statistical analysis contemplated by the comparable profits method is to have a large enough sample to reflect the average profitability of the general class of businesses that are similar to that of Marketing and to reduce the effect of special circumstances peculiar to certain members of the class. Even if size, beyond the size filter already applied in the report, is a relevant factor, it is doubtful that the analysis would be improved by the removal of more than half the companies in the sample.

2. *Marketing performed business functions that were significantly different from those of the nine comparable companies* (Division's Brief in support, pp. 52-71). The Division asserts that the business functions differ significantly because of Marketing's performance of various services, including trademark protection services, real estate services for stores, selection of shop owners, and manufacturing store display fixtures. It is clear from the record that the comparable companies performed some kinds of ancillary services, including management assistance to retailers. Since they distributed vastly different merchandise, including flowers,

books, garden plants, food, and personal care products, it is not surprising that the functions were different in some respects. That these differences have significance for purposes of the present analysis has not been established. We are also not convinced in the present circumstances that component activities that are part of the business of being a distributor should be unbundled into multiple discrete economic functions for purposes of this analysis.

3. *Marketing owned valuable intangibles of a different kind or level* (Division's Brief in support, pp. 71-79). The Division argues that Marketing's intangibles including a unique distribution network, customer lists, sublicense of the Hallmark trademarks, market share, and trained work force distinguish it from the comparable companies. Much of this seems to be merely aspects of going concern value. A distribution company could not operate if it did not have a distribution network, customer lists, market share and a trained work force. We do not understand the Division to be asserting that the nine comparable companies lacked these things but instead that they were different in some significant way from those of Marketing. Like the Administrative Law Judge, we find that those differences were not so significant as to defeat the comparability of the nine companies. It also appears that Hallmark did not have an interest in the Hallmark trademarks beyond using them in the distribution of the products of Cards.

4. *Lack of comparability for varying reasons* (Division's Brief in support, pp. 79-87). The Division states that the nine comparable companies are not "sufficiently similar" to Marketing because of differences in such things as the size of the customer base or the size of the market, differences in the distribution scheme, currency risks involved in foreign markets, the maturity of the businesses, and the level of ancillary manufacturing activities. Again we find that these differences do not rise to a level that should require the elimination of any of the

companies from the sample. The reason for having a sufficiently large sample is the expectation that the differences among the members will average out. As with the foregoing arguments, the Division seems to be asserting that the random sampling techniques contemplated by the comparable profits method are an unreliable engine of truth. Such a conclusion lies well outside the prior precedents on which we rely.

5. *Marketing should have been compensated separately for services it performed and for the use of its intangible assets because such compensation was not reflected in the prices paid for merchandise* (Division's Brief in support, pp. 88-89). This argument seems to assume that these are not activities that an unrelated distributor would conduct for its own benefit. An independent distributor of the merchandise of a single manufacturer under a contract that was terminable by the manufacturer without cause on 90-days notice could be expected to have a strong interest in cementing that relationship and increasing its sales. It is not surprising that the distributor would incur some significant expenses in achieving those ends. If its Berry ratio–the ratio of gross profit to operating expenses–were, for example, 1.2:1 and it could earn another $1.20 for each $1.00 of additional expense, we cannot assume that it would fail to make such expenditure, at least to the point where the marginal returns would decline. If the nine comparable companies have invested less in ancillary activities than Marketing, perhaps it is because their businesses have exhausted their capacity to earn an acceptable return on marginal investment in operating expenses. We cannot conclude that this disqualifies those companies from comparability.

The Division would have us believe that in an arm's-length relationship those expenses would be separately stated and charged to the manufacturer rather than treated as an expense of earning a return on turnover of merchandise. The record contains no support for this proposition.

6. *The analyses of KPMG and Dr. Cody are fatally flawed in various technical respects* (Division's Brief in support, pp. 89-113). The Division states that the methods of petitioner's experts are defective because they might have resulted in Berry ratios that would produce an operating loss, they used financial statements that were in some cases unaudited, and they used different databases as sources of financial information. Moreover, the Division argues that the Berry ratio was the wrong PLI in the present case because it fails to test the pricing of general and administrative services performed for Marketing and the comparable companies used accounting methods that were different from Marketing's. It is also asserted that the expense of returns, allowances and discounts was double counted by being included as an operating expense and also reflected in the price at which accounts receivable were sold at a loss which was in turn treated as an increase in cost of goods sold. We find that these arguments have been persuasively rebutted by petitioner or do not rise to the level of significance that the Division asserts.

It appears from the record that petitioner diligently sought to comply with the law as developed in our prior decisions. It engaged recognized experts to apply the methods required in the section 482 regulations. The contemporaneous KPMG report applies those methods diligently and persuasively supports its conclusions. The principal author of the report testified in its defense at the hearing on direct examination, cross examination and then in rebuttal. Petitioner presented expert testimony which endorsed the conclusions and methods of the report. It is hard to imagine what more could be asked of a taxpayer in complying with the standard of arm's-length pricing prescribed in our earlier decisions and the section 482 regulations. We find accordingly that petitioner has carried its burden of rebutting the presumption of distortion.

In the absence of the presumption, it is the Division's burden to demonstrate the existence of distortion. The Division has presented its case before the Tribunal in an exception 163 pages in length, a memorandum of law 114 pages in length, and a reply memorandum of law 52 pages in length, accompanied by hundreds of pages of appendices and attachments. Much of this material consists of the recitation of factual discrepancies or inconsistencies that appear to have very limited significance or which demonstrate only that the nine comparable companies used in the KPMG report are not identical to Marketing. The Division has failed to find major defects in the methodology of the report. The Division has not demonstrated that some method higher in the regulation's ranking than the comparable profits method should have been used. Although it objects to the use of the Berry ratio, the Division does not show what other profit level indicator should have been used or what the result would be. It has not persuasively attacked the functional analysis which is the beginning point of the selection of the appropriate class of comparable companies. It has not found that the statistical screens applied by KPMG were manipulated to produce a particular result. The section 482 regulations rely upon statistical methods that purport to find only ranges of acceptable answers, not mathematical precision. If these methods are applied in a random way that is faithful to the procedures set out in the regulations, lack of precision does not invalidate the results.

The Division relies on our decision in ***Matter of Tropicana Products Sales*** (Tax Appeals Tribunal, June 12, 2000) in which we rejected the expert report presented by the petitioner in part because it applied the comparable profits method based on companies that were not sufficiently comparable. The report in ***Tropicana*** was prepared specifically for that litigation and was presented three years after the Notice of Deficiency. No prior pricing study had been conducted. The study sought to justify past intercompany pricing in the absence of a written contract or other evidence of how prices were determined or that they were intended to be at arm's length. Here, by contrast, petitioner's experts on intercompany pricing were engaged contemporaneous with the transactions at issue and their role was to advise petitioner on compliance with arm's-length standards. Here, the relationship between Cards and Marketing was well documented with appropriate agreements. The standards of comparability to be applied are of course an intensely factual matter. In ***Tropicana****,* we found that the expert report failed to take into account material differences in several of the purportedly comparable companies. Among these differences were the inclusion of an immature company and the failure to consider the effect of inexperience on operating profits. Also included were companies that operated as purchasing co-ops which may not have dealt at arm's length with their patron-owners. We also found that the petitioner failed to take into account differences in the geographic markets in which the companies operated.

Like the Administrative Law Judge, we think that the factors found determinative in ***Tropicana*** are not present in this case or are present only to a degree that is not material. For example, the petitioner in ***Tropicana*** was engaged in the transportation of a highly perishable commodity into a specific regional market with special demographic characteristics. Marketing was engaged in the national distribution of merchandise. Although some of the nine comparable companies had less expansive markets, there is no reason to believe that this factor had the significance that geography had in ***Tropicana***.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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

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

3. The petition of Hallmark Marketing Corp. is granted; and

4. The Notice of Deficiency dated February 13, 2004 is cancelled.

DATED: Troy, New York
July 19, 2007

/s/ Charles H. Nesbitt
Charles H. Nesbitt
President

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

/s/ Robert J. McDermott
Robert J. McDermott
Commissioner