STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
USV PHARMACEUTICAL CORPORATION	:	DETERMINATION
for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1978, 1979 and 1980.	: :	

Petitioner, USV Pharmaceutical Corporation, c/o Revlon, Inc., 2147 Route 27, Edison, New Jersey 08818, filed a petition for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1978, 1979 and 1980 (File No. 801050).

A hearing was held before Robert F. Mulligan, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on July 26, 1989 at 9:45 A.M., with all briefs to be submitted by October 31, 1990. Petitioner appeared by Morrison & Foerster, Esqs. (Paul H. Frankel, Esq., and Hollis L. Hyans, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUE

Whether petitioner may properly be required to file New York State franchise tax reports on a combined basis with its wholly-owned subsidiary, USV Laboratories, Inc.

FINDINGS OF FACT

Petitioner, USV Pharmaceutical Corporation, was incorporated in Delaware in 1965 and began doing business in New York in 1966. It is amanufacturer and distributor of ethical pharmaceuticals and related products. During the years 1978, 1979 and 1980, petitioner was a subsidiary of Revlon, Inc.[1] During said years, petitioner had manufacturing facilities in the United States and had subsidiary and affiliated corporations in both the ethical and over-the-counter pharmaceutical markets and in the blood business. Its headquarters were in Tuckahoe, New York.

Prior to 1971, petitioner's product line consisted of purchased products.

In or about 1971, CIBA Corp. and Geigy Pharmaceutical Corp. merged and the United States Food and Drug Administration required the newly constituted CIBA-GEIGY Corporation ("CIBA-GEIGY") to divest itself of certain products.

Petitioner entered into a series of agreements with CIBA-GEIGY to acquire the patents, trademarks and other rights for the pharmaceuticals Hygroton and Regroton and for Chlorthalidone, the principal ingredient in each, for $24,000,000.00 in cash, plus certain patents and intangibles. Hygroton and Regroton are oral pharmaceuticals which are prescribed for the treatment of hypertension. Petitioner did not incur or claim any research and development expenses in connection with the acquired pharmaceuticals, as the products had been developed by CIBA-GEIGY.

USV Laboratories, Inc. ("Labs") is a wholly-owned subsidiary of petitioner and was incorporated in Delaware in 1972.

In 1973, Labs manufactured Hygroton and Regroton under a license agreement granting Labs a royalty of 7½% of petitioner's net sales of the products.[2]

In 1974, petitioner contributed the patents, trademarks and other rights it had acquired for Hygroton and Regroton, as well as its rights to Chlorthalidone, to Labs. No gain or loss was recognized, as the transfer constituted a transfer to a controlled corporation pursuant to Internal

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[1]In 1985, Revlon, Inc. sold petitioner to another pharmaceutical company. By the terms of that sale, Revlon, Inc. remains liable for any franchise tax deficiencies determined for the pre-sale period.

[2]Exhibit "L", Internal Revenue Service memorandum attachment, page T-76; Exhibit "2", Kalish memorandum, page 3.

Revenue Code § 351.

In 1974, petitioner and Labs entered into two agreements:

(a) under one agreement, petitioner agreed to provide management services and technical assistance to Labs in return for a fee of 2½% of Labs's sales to petitioner; and

(b) under the other agreement, petitioner became the distributor in the United States and Puerto Rico for all products manufactured by Labs, with the exception of sales of such products to the United States government.

During the years at issue, Labs manufactured Hygroton and Regroton, as well as certain other prescription pharmaceuticals, at its plant in Manati, Puerto Rico. Its operations consisted of combining Chlorthalidone with the inactive ingredients of Hygroton and Regroton, blending and formulating the drugs and packaging the finished products. Labs purchased the Chlorthalidone from Istituto Medicamenta S.P.A., an Italian subsidiary of petitioner's parent, Revlon, Inc.,[3] which manufactured the same under a license from Labs. Labs was a pharmaceutical manufacturer, not a chemical manufacturer. It was not practical for Labs to build a chemical manufacturing plant for the production of Chlorthalidone, as the quantity of the chemical required to manufacture Hygroton and Regroton was too small to justify the large investment necessary for construction of such facility.

Labs sold approximately $1,000,000.00 per year of its production (representing 2% to 5% of total sales)[4] to the United States government and the balance to petitioner.

Shipments to the United States government were sent directly to the designated governmental facility, while shipments to petitioner were shipped to and stored at petitioner's facilities in Tuckahoe, New York. Labs's invoices for the shipments were usually paid by petitioner within 30 to 60 days. The finished inventory generally had a short stay in Puerto Rico due to the climate, which was adverse for storage of pharmaceuticals. Returned goods were destroyed by petitioner in the United States, but only after Labs's authorization. Labs also

[3]Petitioner's Exhibit "2", Kalish memorandum, page 4, footnote 5; Transcript page 212.

[4]Transcript, pages 156 and 200.

authorized credit allowances for such returned goods.

Pricing between petitioner and Labs was arrived at with the assistance of a review by an outside party (the identity of whom is not disclosed in the record) of the functional analysis between petitioner and Labs and after comparing the selling price to the trade and the value of the services performed by petitioner. Consideration was also given to the value of the patents and intangibles owned by Labs. In 1980, for example, prices were set so that the profit split would be 59% to Labs and 41% to petitioner.

Prices paid by petitioner to Labs were established once a year, during the August-November budget period, and remained the same until the budget period in the following year. Even if petitioner increased prices for its customers during the course of a year, the prices it paid to Labs would remain the same.

Prices for Labs's sales to the United States government were within 3% to 4% of prices Labs charged petitioner.

All of Labs's real property and tangible personal property were located in Puerto Rico.

Labs had its own employees, personnel department, payroll department, pension plan and educational assistance programs, as well as its own purchasing department, accounting department, quality control department and outside counsel. Labs had a union, while petitioner's employees were not unionized. Labs did not have a sales or marketing staff. With the exception of the sales made to the United States government, sales of Labs's products were handled by petitioner's sales and marketing staff. Petitioner had a marketing group and also had a pharmaceutical detail force, with sales personnel calling on the medical profession in order to induce physicians to prescribe the drugs in petitioner's product line, including Hygroton and Regroton.[5] As stipulated[6] by the parties, Labs conducted no business in New York State and had no real or personal property, employees or activities in, or any contact with, New York State and conducted all of its business in Puerto Rico.

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[5]Transcript, page 149.

[6]Exhibit "O", Stipulation, page 2.

Petitioner's business locations during 1978, 1979 and 1980 were as follows:[7]

Location	Facility
Tuckahoe and Yonkers, New York	Plant; Research; Administrative Office; Warehouse
Ramsey, New Jersey	Warehouse
Tustin, California	Warehouse; Sales Office (1979)
Carolinas, Puerto Rico	Warehouse; Office
Earth City, Missouri	Warehouse; Sales Office (1979)
Atlanta, Georgia	Sales Office (1979)
Dallas, Texas	Sales Office (1979)
Chicago, Illinois	Sales Office (1979)
Paris, France	Administrative Office (1979)
Michigan	Sales Office (1979)
Hong Kong	Sales Office (1979)

In conjunction with an Internal Revenue Service audit (infra), the Internal Revenue Service pharmaceutical industry coordinator, after a tour of Labs's facilities in 1984, stated in his trip report (in part):

> "Material requirements and product planning initiates with the receipt of forecasts from the marketing officials in the headquarters company."[8]

Petitioner's response to the trip report included the following:

> "USV Tuckahoe is the contract distributor for [Labs's] products. As such, it is standard business practice for distributors to furnish sales volume forecasts. It should be noted that all production planning, scheduling, material requirements, purchasing, purchasing contracts and schedules as well as invoicing and payment is done by [Labs]."[9]

Prior to 1976, Labs qualified for the exclusion of income from sources within possessions of the United States provided for under Internal Revenue Code former § 931. Effective in 1976, the exclusion for domestic corporations was replaced by the Puerto Rico and Possession tax credit under Internal Revenue Code § 936, created by the Tax Reform Act of

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[7]Exhibit O, Stipulation, page 4.

[8] Exhibit "I", page 1 (page T-138).

[9] Exhibit "J", page 1.

1976 (P.L. 94-455). Labs qualified for the credit in 1976 through the years at issue, and also qualified for certain Puerto Rico tax exemption grants. In fact, Labs had been incorporated in the United States rather than Puerto Rico to take advantage of these favorable tax consequences.

The Federal Audits

Petitioner was audited by the Internal Revenue Service for every year from 1972 to 1983 as part of an audit of petitioner's then parent corporation, Revlon, Inc., its subsidiaries and affiliates.

For the audits covering 1972-74 and 1975-76, the Internal Revenue Service proposed to redetermine selling prices of products sold by Labs to petitioner pursuant to Internal Revenue Code § 482, which provides for allocation of income and deductions among controlled taxpayers. The proposal was to recalculate the selling prices on the basis of Labs's costs, plus 25%. No markup was to be permitted on the marketing fee paid by Labs to petitioner (apparently the 2½% fee for marketing services and technical assistance noted in Finding of Fact "8[a]").

Petitioner challenged the proposal, claiming that Labs was being treated as a mere contract manufacturer and that the adjustments took no account of the patents, trademarks and other intangibles which Labs had acquired in 1974, and allowed no element of profit to Labs reflecting such ownership.[10] A request for technical advice was made to the Internal Revenue Service National Office. The request was accepted, but was apparently held in abeyance pending a Federal court decision involving section 482.[11] On or about February 27, 1989, an Internal Revenue Service National Office Technical Advice Memorandum[12] was issued with respect to the proposed adjustments for the years 1974, 1975 and 1976. The issue stated in the memorandum was as follows:

"Whether the Commissioner may, under the authority of I.R.C. § 482,

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[10]Exhibit "3", Kalish letter page 3.

[11]Eli Lilly & Company v. Commissioner, 856 F2d 855 (7th Cir 1988).

[12]Exhibit "4".

> disregard [petitioner's] transfer in [1974], under section 351, of a patent, that it purchased for cash in [1971], to its wholly owned Puerto Rican subsidiary, [Labs], allow the subsidiary essentially a return on its manufacturing costs, and allocate the balance of the subsidiary's income to [petitioner]."

After a lengthy statement of facts and a discussion of the law, the memorandum offered the following conclusions:

> "As to [1974, 1975 and 1976], we think the section 351 transfer of the drug patents to [Labs] must be recognized. This case does not, as far as we know, involve the transfer of appreciated property, or the use of a nonrecognition provision to split-off income from the expenses incurred in producing the income. Any section 482 income allocation
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> for [1974 through 1976] must be based on the factual determination that [Labs'] sale prices to
> [petitioner] were other than at arm's length, having concluded that [Labs] owned the intangibles in question."

The case was then remanded to the Appellate Division of the Internal Revenue Service where it was ultimately conceded that there would be no section 482 adjustments for the years 1974-1976.[13]

Meanwhile, a different Internal Revenue Service team conducted an audit for the years 1977 through 1979. The section 482 adjustment issue was raised, and on April 12, 1984, the Internal Revenue Service pharmaceutical industry coordinator and the audit case manager inspected Labs's facilities in Manati, Puerto Rico. The issue was resolved on July 6, 1984, when Revlon, Inc., petitioner and the other affiliated corporations involved in the audit entered into a closing agreement[14] with the Internal Revenue Service which increased petitioner's

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[13]Transcript, page 171. The reference in the transcript to "May of 1980" would appear to be incorrect, as the Technical Advice Memorandum was not issued until February 27, 1989. Also see petitioner's brief, page 14. According to petitioner, the audit for 1974-1976 was resolved four and one-half years after the audit for 1977-1980 because the Appellate Conferee handling the earlier years would not accept the provisions of the closing agreement executed July 6, 1984 (Findings of Fact "24-27", infra). Transcript, page 187.

[14]The agreement was executed on behalf of Revlon, Inc. and its subsidiaries by Stanley B. Dessen, as Vice President-Taxation of Revlon, Inc. and as Vice President of each subsidiary, on June 26, 1984 and was executed on behalf of the Commissioner of Internal Revenue on July 6, 1984.

taxable income and reduced Labs's income by the following amounts of Internal Revenue Code § 482 adjustments:

Year	Amount of Adjustment
1977	$2,495,000.00
1978	2,053,000.00
1979	1,154,000.00[15]

Petitioner concedes that the prices reflected in the adjustment were 7% to 8% greater than the prices paid by petitioner. The agreed-upon Internal Revenue Code § 482 adjustments were derived from an analysis which may be summarized as follows:

(a) A combined pre-tax profit for each product manufactured by Labs was determined from the combined profit before taxes of petitioner and Labs from sales of the product to third parties other than the United States government.

(b) The combined pre-tax profit was adjusted "to arrive at an amount equivalent to a fully loaded [pre-tax profit] per 936(h)", referring to Internal Revenue Code § 936(h), which sets forth tax treatment of intangible property income.[16]

(c) The Puerto Rico pre-tax profit reported was then calculated by taking the transfer price (the amount deducted by petitioner as cost of goods sold) and deducting Labs's cost of goods and other expenses, including the 2½% management fee paid to petitioner and patent amortization.

(d) The adjustment was then calculated as follows:

(i) The parties agreed that 43.5% of combined pre-tax profit was attributable to

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Exhibit "K", closing agreement, page 2.

16 It is unclear why the closing agreement refers to section 936(h) with respect to the years at issue, as said subdivision was added by P.L. 97-248 and generally applies to tax years beginning after 1982. Petitioner maintains that the adjustments were actually made pursuant to section 482 and further, that even if the adjustments had been made pursuant to the principles of section 936(h), the result would be no different, as the method used under section 936(h) is one of the same methods used under section 482 (see: Petitioner's Reply Brief, page 10).

petitioner and 56.5% was attributable to Labs.

(ii) The section 482 pricing adjustment was the difference between the amount attributable to Labs and Labs's pre-tax profit reported.

(iii) The difference reduced petitioner's cost of goods sold reported for the products and increased petitioner's taxable income by the same amount.

(e) The closing agreement stipulated that it was to "be extended to encompass the taxable years 1980, 1981, 1982, 1983, and subsequent years to the extent that any pre-TEFRA inventory (as defined in proposed regulations under Section 936[h]) is sold to third parties."[17] In a report prepared for submission to the visiting Internal Revenue Service pharmaceutical industry coordinator on April 12, 1984,[18] Labs and another subsidary of petitioner, USV (P.R.) Development Corporation, were referred to, collectively, as "USV-PR". It was stated that both corporations had qualified under Internal Revenue Code § 936 for treatment as possessions corporations.

While the point was not explained or raised at the hearing, the report indicates that both subsidiaries used the Manati plant and shared the same personnel. The two corporate entities seem to have been divided between product lines, with Labs manufacturing Hygroton and Regroton, as well as the pharmaceuticals Arlidin and Pertofane, and USV (P.R.) Development Corporation manufacturing Doriden and A-200 Pyrinate. The report stated, in part:

> "Each company has a separate tax exemption grant which covers particular products. An application for a third grant of tax exemption has been applied for by USV Labs. The third grant will be transferred to a separate

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[17]Exhibit "N", Federal Income Tax Examination Changes for 1980-1982, shows section 482 adjustments for said years as follows:

Year	Adjustment
1980	$ (182,000.00)
1981	2,554,000.00
1982	3,361,000.00

The negative adjustment for 1980 would seem to indicate that petitioner actually overpaid for its 1980 purchases.

[18]Exhibit "I".

corporation, USV Products, Inc."[19]

Distinguishing the section 936 subsidiaries is even more difficult after review of memoranda[20]submitted to the Internal Revenue Service in connection with the audit for the years 1972-1976, which refer to an entity named USV Pharmaceutical Manufacturing Corporation as "USV-PR". From the context of the memoranda, it appears that USV Pharmaceutical Manufacturing Corporation could actually be Labs. However, the Technical Advice Memorandum (Finding of Fact "24") specifically refers to Labs by name. Neither USV Pharmaceutical Manufacturing Corporation nor USV Products, Inc., is referred to in the Technical Advice Memorandum.

<u>The New York State Audit</u>

Petitioner filed its New York State corporation franchise tax reports for the calendar years 1978, 1979 and 1980, computing its tax based on allocated capital, and, after utilizing tax credits, paid $250.00 minimum tax for each year.

A number of adjustments were made upon audit by the New York State Division of Taxation. However, after a conference in the former Tax Appeals Bureau, only one issue remained: that of combined reporting. The auditor had determined that petitioner was required to file combined franchise tax reports with Labs. The basis for this determination is stated in the field audit report:

> "It was determined on audit that taxpayer should be filing on a combined basis with its wholly owned subsidiary, USV Laboratories, Inc. (66-0313587)[.] USV Laboratories is a Puerto Rican Company that was incorporated in Delaware on June 30, 1972. It's [sic] business group code number is 2830 and the corporation's address is: P.O. Box 345, Manati, Puerto Rico 00701.
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> USV Laboratories manufactures ethical pharmaceuticals and 80% of their sales are attributable to the previously mentioned product Hygroton. The subsidiary holds its own patents and they are currently the only manufacturer of this product. The subsidiary does not have its own sales force but sells its products directly back to the parent who then sells it in the United States. The taxpayer [sic] obtains the bulk of its raw materials from overseas.

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[19] Exhibit "I", unnumbered footnote to Section I, Overview.

[20] Exhibits "2" and "3".

> The taxpayer and its subsidiary are part of a unitary business. All requirements for combined reporting are met. These include ownership, substantial intercompany transactions and a unitary business. For all of these above mentioned reasons the subsidiary USV Laboratories is being required to file on a combined basis with its parent USV Pharmaceutical Corporation beginning with calendar year ended 1978.
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> Transactions between the taxpayer and its other subsidiaries are not substantial enough to require combined reporting."[21]

It is noted that prior to 1976, Puerto Rico source income of a domestic corporation was not taxed in New York, as said income was excluded from Federal taxable income by virtue of Internal Revenue Code former § 931 (Finding of Fact "20"). In 1976, when the exclusion was replaced by a credit under Internal Revenue Code § 936, the Puerto Rico source income was no longer excluded from Federal taxable income and thus could be subjected to New York tax.

At the hearing, the audit team leader admitted that no examination had been made as to whether there was functional integration between petitioner and Labs, whether any economies of scale existed, or whether there was common purchasing, common advertising, unity of use or unity of operation. He also conceded that no inquiry had been made as to whether there was arm's-length pricing between petitioner and Labs, or as to the degree of independence with which Labs operated.

Petitioner executed a series of consents extending the period of limitation on assessment for the years 1978 and 1979 to January 31, 1984. On December 16, 1983, statements of audit adjustment and notices of deficiency were issued to petitioner asserting tax and interest due as follows:

Period Ending	Tax	Interest	Total
12/31/78	$558,652.00	$325,855.44	$884,507.44
12/31/79	409,768.00	202,935.98	612,703.98

The recomputation of tax was based on application of the tax rate to the allocated combined entire net income of petitioner and Labs. The combined business allocation percentages used

21 Exhibit "S", field audit report, pages 3-4.

on audit were:

Year	Percentage
1978	36.9437%
1979	32.0346%
1980	34.5344%

The deficiences in tax were the amounts due after the allowance of investment tax credits of $218,650.00 for 1978 and $346,456.00 for 1979 and a DISC export credit for 1978. No statement of audit adjustment or notice of deficiency was issued for the year 1980, as tax liability calculated upon audit was eliminated by an investment tax credit of $478,295.00 allowed for said year.

The following adjustments were made pursuant to the aforementioned Tax Appeals Bureau conference:

(a) The DISC export credit was recomputed based upon shipments from New York. This resulted in a $36.00 credit for 1979 and a $110.00 credit for 1980.

(b) For 1979, petitioner's investment allocation percentage was adjusted to reflect an issuer's allocation for private export funding of 100%, not 0% as originally claimed. Accordingly, allocated investment income for 1979 was reduced from $457,380.00 to $373,207.00.

(c) While it was not mentioned in the Report of Tax Conference, it appears from the workpapers that a minimum tax on combined subsidiary of $250.00 per year was eliminated in the recalculation after the conference.

(d) Additional tax due for each year was recomputed as follows:

Period Ended	Additional Tax Due
12/31/78	$558,402.00
12/31/79	401,065.00
12/31/80	-0-

Additionally, the investment tax credit charged against 1980 was reduced from $478,295.00 to $477,935.00, a difference of $360.00. This evidently represents the $110.00 DISC export credit and $250.00 minimum tax on combined subsidiary.

Audit Policy As To Combined Reporting

In 1984, the Combined Policy Subcommittee was formed within the Audit Division of the Division of Taxation for the purpose of reviewing issues related to combined reporting and making policy recommendations. The subcommittee consists of representatives from the District Office Audit Bureau, the Central Office Audit Bureau and, from time to time, the Audit Evaluation Bureau.

Prior to the Decision of the State Tax Commission in Matter of Digital Equipment Corp. (State Tax Commission, October 14, 1985), audit policy was to require combined reports where there was a final Federal determination with Internal Revenue Code § 482 adjustments for transactions with a section 936 corporation. The committee interpreted Digital as holding that Federal changes under section 482 would cure any presumed distortion created by intercompany transactions. Consequently, although the Audit Division did not agree with the holding in Digital, audit policy was changed and it was decided not to pursue combination in such cases. However, the policy question surfaced again, after the decision of the Court of Appeals in Campbell Sales Company v. New York State Tax Commission (68 NY2d 617, cert denied 479 US 1088). In early 1987, after Campbell, the Audit Division requested Counsel for the Department of Taxation and Finance to advise whether Digital or Campbell should be followed. Sometime in 1988, an opinion of Counsel advised that Campbell was controlling. Since that time, audit policy has been to require combination in cases involving taxpayers with section 936 subsidiaries and section 482 adjustments,[22] where more than 50 percent of transactions are intercorporate and the business is deemed unitary. It appears, however, that although notices of deficiency have been issued in some such cases, most of the cases are still open, with consents extending the period of limitation on assessment having been obtained where the period would have otherwise expired.[23]

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[22]The Division of Taxation acknowledges that Campbell did not involve a section 482 adjustment or a section 936 corporation.

[23]As pointed out by petitioner, Digital was cited in an Advisory Opinion of the Commissioner of Taxation and Finance issued after 1988 (United States Surgical Corporation, Advisory

The parties have stipulated that if the position of the Division of Taxation is ultimately sustained, petitioner is entitled to a reduction of the deficiencies consistent with the Administrative Law Judge determination in Matter of Belding Heminway Co., Inc., (Division of Tax Appeals, September 9, 1988). Said case held that intercompany charges for administrative services and other specialized services did not constitute business receipts. Application of such rule to this case would reduce the receipts factor and additional receipts factor for each year as follows:[24]

Year	Existing Receipts Factor and Additional Receipts Factor	Reduced Receipts Factor and Additional Receipts Factor
1978	11.6865%	8.8987%
1979	10.4986%	7.6898%
1980	14.2020%	7.6336%

This would reduce the deficiencies for 1978 and 1979 by $28,620.00 and $31,150.00, respectively, and increase the income tax carry forward for 1980 by $36,702.00.[25]

SUMMARY OF THE PARTIES' POSITIONS

Petitioner claims that it should not be required to file combined reports with Labs. Its argument is essentially as follows:

(a) There was no distortion of petitioner's income, as all transactions with Labs were at arm's length, as exemplified by the Internal Revenue Service disposition of the section 482 adjustments.

(b) Petitioner and Labs did not conduct a unitary business.

(c) Requiring petitioner and Labs to file a combined franchise tax report violates both the Due Process Clause and the Commerce Clause of the United States Constitution.

Opinion, January 31, 1989, TSB-A-89[2] C).

[24]Petitioner's Exhibit 5.

[25]Id.

(d) Other taxpayers in similar situations have not been required to file combined reports, thus denying petitioner equal protection under the law and violating the Equal Protection Clause of the United States Constitution.

The Division of Taxation claims that petitioner and Labs are engaged in the unitary business of the manufacture and sale of ethical pharmaceuticals and that there were substantial intercorporate transactions between them; that requiring the corporations to file franchise tax reports on a combined basis accurately reflects items of income, gain, loss and deduction attributable to New York State for the period at issue; and that such required combination was not violative of the United States Constitution.

Petitioner submitted 16 proposed findings of fact. Proposed findings 1, 2, 3, 4, 6, 7, 8, 10, 11, 12, 14 and 15 are accepted. Proposed findings 5, 9, 13 and 16 are accepted in part and rejected in part:

(a) Proposed finding 5 is accepted, except for the use of the word "independently". While Labs's operations were for the most part autonomous, there was no showing that Labs was completely independent of petitioner's control.

(b) Proposed finding 9 is accepted, except for the use of the word "minor". Adjustments of 7% to 8% amounting to $2,053,000.00 for 1978 and $1,154,000.00 for 1979 are not necessarily "minor".

(c) Proposed finding 13 is accepted, except to the extent it provides that there was no investigation of the management of petitioner or Labs, as that fact was not adequately shown by petitioner.

(d) Proposed finding 16 is accepted, except to the extent that it provides that certain audits were closed without requiring combination "even after 1987," as that fact was not adequately shown by petitioner.

Aside from the rejected portions of the proposed findings of fact noted above, the proposed findings have been incorporated into the Findings of Fact herein to the extent deemed material to the case.

CONCLUSIONS OF LAW

A. During the years at issue, Tax Law § 211.4 provided, in pertinent part, as follows:

> "In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all of 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 tax commission may require; provided...that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary, because of intercompany 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."

Tax Law § 211.5, which is referred to in section 211.4, provides, in substance, that agreements, understandings, or arrangements which cause a taxpayer's activity, business, income or capital within the State to be improperly or inaccurately reflected, may be disregarded in making adjustments which equitably determine tax due.

B. The concept embodied in Tax Law § 211.4, combined reporting, was introduced to the Tax Law by chapter 640 of the Laws of 1920. This legislation added what was then numbered as subdivision 9 of section 211. It provided that where both parent and subsidiary were liable to file New York reports, the State Tax Commission[26] could require them to file a consolidated report. Chapter 322 of the Laws of 1925 deleted the requirement that each of the related companies be subject to the reporting obligation, but limited the Tax Commission's authority "to equitably adjust the tax" to cases where it appeared to the Commission that "any arrangement exists in such a manner as to improperly reflect the business done, the segregable assets or the entire net income earned from business done in this state." In a letter to the Counsel to the Governor, dated March 31, 1925, the President of the State Tax Commission quoted a memorandum of the Counsel of the State Tax Department in support of the 1925 amendment, stating as follows (in pertinent part):

> "This bill was prepared by Tax Commissioner Merrill and is designed to prevent tax evasion. It permits the tax commission to require consolidated reports of interrelated corporations and thus procure a comprehensive picture of

[26]Effective September 1, 1987, the term "State Tax Commission", as used in Tax Law § 211, was to be deemed to refer to the Division of Taxation or the Commissioner of Taxation and Finance (Tax Law § 2026).

the property and financial transactions thereof. It prevents the parent company, which is not required to report to the tax commission, from covering up the facts in relation to its subsidiary and vice versa, so that regardless of whether the parent or subsidiary company is subject to tax the proper amount may be exacted."[27]

Subdivision 9 of section 211 was renumbered to read subdivision 8 by chapter 716 of the Laws of 1940. Chapter 415 of the Laws of 1944 revised section 211 and divided the provisions of then existing subdivision 8 between two new subdivisions numbered 4 and 5, which are essentially the subdivisions 4 and 5 referred to in Conclusion of Law "A", herein. [28]

C. Tax Law § 211.4 has been the subject of a great deal of controversy over most of the past two decades, much of which seems to stem from the four-to-three decision of the Court of Appeals in Wurlitzer Company v. State Tax Commission (35 NY2d 100).

In Wurlitzer, the four-judge majority held that Wurlitzer and its foreign finance company subsidiary were properly combined by the Division of Taxation:

"Subdivision 4 of section 211 of the Tax Law expressly empowers the Tax Commission to require a combined report because of intercompany transactions, where certain conditions are found to exist. The use in subdivision 4 of the word 'or' with reference to subdivision 5, under which the Commission, where it appears that a taxpayer's income within the state is improperly or inaccurately reflected, may, in its discretion, require combined reports or may include fair profits in entire net income, makes it clear that when the Commission acts pursuant to the power conferred by subdivision 4, it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected. The statute envisions and covers separate situations.

* * *

Neither in the statute nor the regulations promulgated under it, is there any requirement of 'unfairness' in transactions between the affiliated corporations. True, the taxpayer would read this requirement into its interpretation of the statute and the dissent agrees. However, the purpose of article 9-A of the Tax Law of [sic] the Commission's regulations is to permit the imposition of a franchise tax on foreign corporations doing business in the State, measured by the net income allocated to the business done here. The meaning of particular language should not be stressed beyond its obvious meaning where legislative history and policy do not so dictate." (Id. at 105.)

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[27]Letter, John F. Gilchrist, President, State Tax Commision, to James A. Parsons, Acting Counsel to the Governor, March 31, 1925 (included in Bill Jacket Collection for chapter 322, Laws of 1925).

[28]The legislative history of Tax Law § 211.4 was also discussed in the minority opinion of the Court of Appeals in Wurlitzer Company v. State Tax Commission (35 NY2d 100, 111-112).

Judge Jones, on behalf of the three-judge minority, wrote in part, as follows:

> "I am accordingly persuaded that the authority of the Tax Commission to require combined returns from a New York corporate taxpayer and its non-New York corporate subsidiary extends only to situations in which it is properly found that in consequence of unfair and manipulative intercorporate transactions the net income of the New York corporate taxpayer is improperly distorted. Ours is not a unitary tax system in which corporate identity is ignored. Additionally I note that otherwise to construe the statute would be to raise serious constitutional questions as to the power of the Tax Commission to impose a privilege type franchise tax on a foreign corporation exclusively engaged in interstate commerce.
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> In this case, the Tax Commission has itself found a valid business purpose, independent of tax considerations, for the formation by Wurlitzer of its corporate subsidiary...and there is no finding that the intercorporate transactions between them were unfair or unreasonable or that in consequence thereof there has been a distortion of the entire net income of Wurlitzer." (Id. at 112.)

D. Regulations in effect during the periods at issue in Wurlitzer (fiscal years ending March 31, 1965 through March 31, 1967) and at the time of the Court of Appeals decision (July 11, 1974) read, in pertinent part, as follows:

> "5.28 (formerly Art. 560), Combined Reports: When Required or Permitted (Law Sec. 211.4). a. Combined reports may be required or permitted in the following cases:
>
> 1. Where any taxpayer owns or controls, either directly or indirectly, substantially all the capital stock of one or more other corporations.
>
> * * *
>
> b. In any case where the test of stock ownership or control set forth above is met, a combined report may be permitted or required by the State Tax Commission, in its discretion. In determining whether, in a case where the test of stock ownership or control is met, the tax will be computed on the basis of a combined report, the State Tax Commission will consider various factors, including the following: (1) whether the corporations are engaged in the same or related lines of business; (2) whether any of the corporations are in substance merely departments of a unitary business conducted by the entire group; (3) whether the products of any of the corporations are sold to or used by any of the other corporations; (4) whether any of the corporations perform services for, or lend money to, or otherwise finance or assist in the operations of, any of the other corporations; (5) whether there are other substantial intercompany transactions among the constituent corporations.
>
> c. The State Tax Commission may not require, although it may permit, the inclusion in a combined report of foreign corporations not doing business in New York so as to be subject to tax under Article 9-A and which are therefore not 'taxpayers', unless the State Tax Commission determines that such inclusion is necessary in order properly to reflect the tax liability of the taxpayers included in the group, because of intercompany transactions or some agreement, understanding,

arrangements or transaction referred to in subdivision 5 of section 211 of the Tax Law (section 3.6)."

E. The aforementioned regulations were replaced by corporation franchise tax regulations promulgated by the State Tax Commission on August 31, 1976, applicable to taxable years beginning on or after January 1, 1976. It is these regulations which were in effect during the period at issue herein and they provided, in pertinent part, as follows:

"6-2.1 General (Tax Law, § 211, subd. 4). -- (a) The reporting requirements of article 9-A contemplate that each corporation is a separate taxable entity and shall file its own report. However, the Tax Commission, in its discretion, may require a group of corporations to file a combined report or may grant permission to a group of corporations to file a combined report where the requirements of stock ownership or control are met. In addition, in deciding whether it will require or permit combined reporting, the Tax Commission will consider whether the group of corporations is engaged in a unitary business and whether there are substantial intercorporate transactions among the corporations.

(b) Each corporation in the combined report must compute and show the tax which would have been required to be shown if filed on a separate basis.

6-2.2 Initial Requirement -- Capital Stock (Tax Law, § 211, subd. 4). -- (a) In deciding whether to permit or require a group of corporations to file a combined report, the Tax Commission will first determine whether:

(1) the taxpayer owns or controls, either directly or indirectly, substantially all of the capital stock of all the other corporations which are to be included in the combined report;

* * *

6-2.3 Other Requirements -- Exercise of Discretion (Tax Law, § 211, subds. 4 and 5). -- (a) After the requirement described in section 6-2.2 of this Subpart has been met, the Tax Commission may permit or require a group of corporations to file a combined report if this method of reporting properly reflects the activities in New York State of the corporations. If the income or capital of a taxpayer is improperly or inaccurately reported because of intercorporate agreements, understandings or arrangements, the Tax Commission may permit or require the corporations to file a combined report. In deciding whether to permit or require combined reports the following two (2) broad factors must be met:

(1) the corporations are in substance parts of a unitary business conducted by the entire group of corporations, and

(2) there are substantial intercorporate transactions among the corporations.

(b) In deciding whether each corporation is a part of a unitary business, the Tax Commission will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

(1) manufacturing or acquiring goods or property for other corporations in

the group; or

(2) selling goods acquired from other corporations in the group; or

(3) financing sales of other corporations in the group.

The Tax Commission will consider a corporation to be a part of a unitary business if it is engaged in the same or related lines of business as the other corporations in the group, such as:

(4) manufacturing similar products; or

(5) performing similar services; or

(6) performing services for the same customers.

(c) In determining whether the substantial intercorporate transaction requirement is met, the Tax Commission will consider only transactions directly connected with the business conducted by the taxpayer, such as described in paragraph (1), (2), or (3) of subdivision (b) of this section. Service functions, such as accounting, legal, and personnel will not be considered. The substantial intercorporate transaction requirement may be met where as little as fifty percent (50%) of a corporation's receipts are from any qualified activities. It is not necessary that there be substantial intercorporate transactions between any one member with every other member of the group. It is, however, essential that there be substantial intercorporate transactions among all members of the combined group.

(d) The decision to permit or to require a combined report or to require separate reports must be based on the facts in each case... [examples omitted].

6-2.5 Corporations Not Required or Permitted to File a Combined Report (Tax Law, § 211, subd. 4). -- (a) A foreign corporation not subject to tax will not be required to be included in a combined report unless the requirement described in section 6-2.2 of this Subpart has been met and the Tax Commission determines that inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:

(1) intercorporate transactions; or

(2) some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected [example omitted]."

F. The regulations were amended by new provisions filed November 30, 1983 effective for all taxable years ending on or after December 31, 1983 and which are still in effect. While these regulations were not in effect during the period at issue herein, it is noted that the Tax Appeals Tribunal, in Matter of Autotote, Ltd. (Tax Appeals Tribunal, April 12, 1990), applied same to a period which would have been covered by the 1976 regulations. The current regulations provide, in pertinent part, as follows:

"6-2.1 General. [Tax Law, § 211(4)] (a) Every corporation is a separate taxable entity and shall file its own report. However, the Tax Commission, in its discretion, may require a group of corporations to file a combined report or may grant permission to a group of corporations to file a combined report where:

(1) the requirement of stock ownership or control (as described in section 6-2.2[a] of this Part) is met;

(2) the group of corporations is engaged in a unitary business (as described in section 6-2.2[b] of this Part); and

(3) the other requirement set forth in section 6-2.3 or section 6-2.5(a) of this Part, as the case may be, has been met.

(b) Each corporation in the combined report must compute and show the tax which would have been required to be shown if filed on a separate basis.

(c) The decision to permit or require a combined report will be based on the facts in each case using the requirements set forth in this Part.

6-2.2 Capital stock and unitary business requirements. [Tax Law, § 211(4)]

(a) Capital stock requirement. (1) In deciding whether to permit or require a group of corporations to file a combined report, the Tax Commission will first determine whether:

(i) the taxpayer owns or controls, either directly or indirectly, substantially all of the capital stock of all the other corporations which are to be included in the combined report; or

* * *

(b) Unitary business requirement. (1) In deciding whether a corporation is part of a unitary business, the Tax Commission will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

(i) manufacturing or acquiring goods or property or performing services for other corporations in the group; or

(ii) selling goods acquired from other corporations in the group; or

(iii) financing sales of other corporations in the group.

(2) The Tax Commission, in deciding whether a corporation is part of a unitary business, will also consider whether the corporation is engaged in the same or related lines of business as the other corporations in the group, such as:

(i) manufacturing or selling similar products; or

(ii) performing similar services; or

(iii) performing services for the same customers [examples omitted].

6-2.3 Other requirement. [Tax Law, § 211(4) and (5)].

* * *

(b) If the requirements described in section 6-2.2 of this Part have been met, the Tax Commission may permit a corporation which is not a taxpayer to be included in a combined report if reporting on a separate basis distorts the activities, business, income or capital of one or more taxpayers.... The activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations.

(c) In determining whether there are substantial intercorporate transactions, the Tax Commission will consider transactions directly connected with the business conducted by the taxpayer, such as:

(1) manufacturing or acquiring goods or property or performing services for other corporations in the group;

(2) selling goods acquired from other corporations in the group;

(3) financing sales of other corporations in the group; or

(4) performing related customer services using common facilities and employees.

Service functions will not be considered when they are incidental to the business of the corporation providing such service. Service functions include, but are not limited to, accounting, legal and personnel services. The substantial intercorporate transaction requirement may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities described in this subdivision.

* * *

6-2.5 Corporations not required to file a combined report. [Tax Law, § 211(4)] (a) A foreign corporation not subject to tax will not be required to be included in a combined report unless the requirements described in section 6-2.2 of this Part have been met and the Tax Commission determines that inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:

(1) substantial intercorporate transactions (see subdivision (c) of section 6-2.3 of this Part); or

(2) some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected [example omitted]."

G. While in Wurlitzer, the Court of Appeals held that improper or inaccurate reflection of income or capital was not a condition precedent to combined reporting, said Court has also recognized that the purpose of the statute is to avoid distortion of income. In Coleco Industries, Inc. v. State Tax Commission (92 AD2d 1008 [3d Dept 1983], affd 59 NY2d 994), the Appellate Division reviewed the relevant cases extant and held:

> "The teaching of these cases is that the presence or absence of no single factor is decisive in determining whether combined reporting is mandatory. Ultimately, the question is whether, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion and of more realistically portraying true income" (92 AD2d at 1009).

This view was adopted by a unanimous memorandum decision of the Court of Appeals (59 NY2d 994).

H. The position of the majority in Wurlitzer was reaffirmed in the six-to-one decision of the Court of Appeals in Campbell Sales Company v. New York State Tax Commission (68 NY2d 617). The Court echoed its position in Wurlitzer that it was not a condition precedent that the income or capital of a taxpayer be improperly or inaccurately reflected before the State Tax Commission could exercise its discretion and require combined reports because of intercorporate transactions. Alluding to the dissenting opinion of Judge Kaye, the court noted that many of the arguments advanced by Judge Kaye had been made by the dissenters in Wurlitzer and had been rejected by the majority. The court stated:

> "[o]ur construction of the statute in Wurlitzer constitutes binding precedent on all members of this court (citations omitted)" (68 NY2d at 620).

The court continued:

> "Petitioner and its related corporations have substantial intercompany transactions, which demonstrate that they have a symbiotic relationship to each other and that petitioner is a vital link in the over-all enterprise. Moreover, since its inception, petitioner has exclusively solicited sales for Campbell's Soup in 34 states.
>
> Finally, it was incumbent upon petitioner to establish that the allocation formula utilized by the Commission does not properly reflect the business it transacts in New York (Matter of Eastman Kodak Co. v. State Tax Commn., 33 AD2d 298, 303, affd 30 NY2d 558). That burden has not been met here" (68 NY2d at 620).

Judge Kaye's dissenting opinion notes that New York has chosen not to adopt a unitary business test, stating:

> "[o]ur Tax Law provides on its face that the Commission may not require a combined report unless necessary 'in order properly to reflect the tax liability under

this article', and this statutory threshold has not been met -- indeed it was not even recognized -- in the case at bar" (Id. at 622).

I. The dichotomy posed by the majority and minority positions in both Wurlitzer and Campbell appears to be due to the interpretation of the last phrase of the first sentence of Tax Law § 211.4:

"provided...that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary, because of intercompany 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."

The majority, in each case, viewed the words "in order properly to reflect the tax liability under this article" in the disjunctive with respect to the words "because of intercompany transactions" and limited the former as relating only to the agreements, understandings, arrangements and transactions referred to in Tax Law § 211.5.

J. In Standard Manufacturing Company, Inc. v. State Tax Commission (114 AD2d 138 [3d Dept 1986], affd 69 NY2d 635, appeal dismissed 481 US 1044), the Appellate Division found ample evidence that Standard and its subsidiary were engaged in a unitary business and had substantial intercompany transactions. The Court then reasoned:

"Having so concluded, 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 and of more realistically portraying true income. In answering this question, no single factor is decisive [citing Coleco, supra]. Here, in view of the substantial extent and nature of the intercorporate transactions between [parent and subsidiary], we conclude that combined reporting would, in this case, result in a more realistic portrayal of true income, thus avoiding any distortion" (Id. at 141).

The Court of Appeals unanimously affirmed the judgment of the Appellate Division for the reasons stated in the Appellate Division opinion (69 NY2d 635). It is noted that the Court of Appeals case was decided on December 16, 1986, slightly more than six months after that court's decision in Campbell and that Judge Kaye, who dissented in Campbell, concurred in Standard.

K. The New York law, then, seems to be that while it is not a condition precedent that income or capital of a taxpayer be improperly or inaccurately reflected before the Division of

Taxation may exercise its discretion and require combined reports because of intercorporate transactions (Wurlitzer and Campbell), the courts will determine whether, under all of the circumstances of the intercompany relationship, combined reporting will avoid distortion and more realistically portray true income (Coleco and Standard). It has been suggested that distortion of income, while not a condition precedent, is a condition subsequent to requiring combined reporting in intercorporate transaction situations (see, Gombinski, Continuing Unitary Tax Dilemma, State and Local Taxation, April 1989, at 79).

L. Application of the Tax Law and regulations to the facts of the instant case shows the following:

(1) There is no question that the statutory requirement for control has been met, as Labs was a wholly owned subsidiary of petitioner.

(2) Under the regulations, petitioner and Labs were, in substance, parts of a unitary business. Labs was petitioner's sole supplier of Hygroton and Regroton and, with the exception of government sales, petitioner was Labs's sole distributor of such products (see, 20 NYCRR 6-2.2[b]; 20 NYCRR former 6-2.3[b]).

(3) There were clearly substantial intercorporate transactions between petitioner and Labs, as required by 20 NYCRR 6-2.3(b) and 6-2.5(a)(1) and by 20 NYCRR former 6-2.3(a)(2) and 6-2.5(a)(1). At least 95% of Labs's receipts were from sales to petitioner, substantially more than the 50% minimum set forth in 20 NYCRR 6-2.3(c) and 20 NYCRR former 6-2.3(c).

M. The remaining questions are:

(1) Whether, under all of the circumstances of the intercompany relationship, combined reporting by petitioner and Labs will avoid distortion and more realistically portray true income;

(2) Whether, aside from meeting the regulatory criteria for a unitary business (Conclusion of Law "L [2]", supra), the relationship between petitioner and Labs meets the constitutional requirements for state taxation of out-of-state income of a unitary business; and

(3) Whether the fact that other pharmaceutical manufacturers with Internal Revenue Code

§ 482 adjustments for section 936 subsidiaries were not combined with their subsidiaries, denied petitioner equal protection under the law.

N. Petitioner has failed to sustain its burden of proof imposed by Tax Law § 1089(e) to show that under all of the circumstances of the intercompany relationship between petitioner and Labs, combined reporting by the two corporations would not avoid distortion and would not more realistically portray true income. While petitioner has shown that Labs operated with considerable autonomy and has also shown that inventory was purchased from Labs at prices at least close to arm's length, there are numerous factors which weigh heavily against petitioner's position, or which have not been satisfactorily explained:

(1) Intercorporate transactions with petitioner, as noted above, represented 95% to 98% of Labs's sales.

(2) With the exception of the 2% to 5% of Labs's sales which were made to the United States government, petitioner operated as Labs's marketing and sales arm. Petitioner provided Labs with marketing forecasts which were apparently the starting point for the calculation of Labs's production planning and material requirements. Moreover, petitioner's detail sales personnel conducted sales and promotional functions with the medical profession for products manufactured by Labs.

(3) All of Labs's non-governmental production was shipped to petitioner's New York facility for distribution. Returned merchandise was destroyed in New York on Labs's authorization.

(4) The prices paid by petitioner were set once each year and Labs received the same price for the year, apparently without regard to whether Lab's costs had increased during the year. Petitioner, however, was free to increase prices to its customers at any time.

(5) While prices charged to petitioner by Labs were close to arm's length, petitioner concedes that said prices were 7% to 8% less than the adjusted prices set forth in the closing agreement with the Internal Revenue Service. It is noted that the adjustment for 1978 was $2,053,000.00 and the adjustment for 1979 was $1,154,000.00.

(6) Although petitioner claims that the adjustments in the closing agreement were reported to New York State, they clearly could not have been reported at the time of the audit, as the audit had been completed and notices of deficiency issued by December 16, 1983. The closing agreement was not executed until July 6, 1984.

(7) Petitioner provided management and technical services to Labs for a fee of 2½% of sales.

(8) The record is virtually silent as to the identity and location of Labs's directors and high level officers. Petitioner did not show that the two corporations did not share common directors or that Labs's directors were not controlled by petitioner. Also, petitioner did not identify Labs's senior officers or show that they were independent of petitioner. The material presented to the Internal Revenue Service at the time of the visit to Labs's plant indicates that Labs's highest ranking officer in Puerto Rico was its vice-president and plant manager.[29]

(9) Labs and another subsidiary of petitioner, USV (P.R.) Development Corporation, appear to have shared not only the same plant at Manati, Puerto Rico, but the same personnel (Finding of Fact "27"). The major distinction between the two subsidiaries seems to have been the different product lines.[30]

While any one of the above factors may not be enough to necessitate combined reporting, taken as a whole, they show the interdependent relationship between petitioner and Labs and that combination of the two entities is essential for portraying the true income of what was virtually one business.

O. Even assuming that the Internal Revenue Service had found prices between petitioner and Labs to have been arm's length, it does not necessarily follow that there would have been no

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[29]It appears that Stanley B. Dessen, who executed the closing agreement with the Internal Revenue Service on behalf of Revlon, Inc., petitioner, and Labs, as an officer of each corporation, was based at Revlon, Inc.'s headquarters in New York.

[30]As noted in Finding of Fact 29, no subsidiary besides Labs was required to file a combined report with petitioner, as intercompany transactions with said subsidiaries were deemed "not substantial enough".

distortion of income and that petitioner's true income would have been portrayed. While there are similarities between Internal Revenue Code § 482 and Tax Law § 211.4, the statutes are clearly distinguishable. The basic aim of Internal Revenue Code § 482 is to examine intercompany transactions to see if they are bona fide, e.g., to determine if the prices and terms in such transactions are truly arm's length (Treas Reg § 1.482-1[c]). The Internal Revenue Service cannot compel a parent and subsidiary to file a consolidated return (Treas Reg § 1.482-1[b][3]). Tax Law § 211.4 is broader, and envisions more than an examination of intercorporate pricing, requiring examination of the entire intercorporate relationship.

P. Requiring petitioner and Labs to file combined New York State Franchise Tax reports does not violate either the Due Process Clause (US Const, 14th Amend, § 1) or Commerce Clause (US Const, art I, § 8, cl 3). The factors set forth in Conclusion of Law "N", supra, serve also to show that petitioner has failed to sustain its burden of proving that Labs was a discrete business enterprise. Thus, petitioner and Labs constituted a unitary business with sufficient nexus for taxation by New York State. (Mobil Oil Corp. v. Commr. of Taxes of Vermont, 445 US 425 [1980]). Petitioner's reliance on F. W. Woolworth Co. v. Taxation & Revenue Department of New Mexico (458 US 354 [1982]) is misplaced. The subsidiaries at issue in Woolworth enjoyed a degree of autonomy which Labs was not shown to have had. Accordingly, Woolworth is clearly distingishable from the instant case.

Q. Petitioner's claim that since the Division of Taxation did not combine certain other taxpayers and their section 936 subsidiaries with section 482 adjustments between the issuance of the Digital decision in 1985 and the 1987 request for an opinion of Counsel following Campbell, assertion of tax against petitioner denies it of equal protection of law, is without merit. The Audit Division was not administering Tax Law § 211.4 "with an evil eye and unequal hand" (Matter of Dora P., 68 AD2d 719, 731),[31] but, rather, was attempting to conduct

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[31]Petitioner, to sustain its equal protection claim, must prove both the "evil eye" and "uneven hand" requirements, i.e., it must show not only that the law was not applied to others similarly situated, but also that the selective application of the law was deliberately based on an impermissible standard.

audits during said period under its interpretation of existing precedent. This was not a violation of the Equal Protection Clause (US Const, 14th Amend, § 1).

R. In accordance with the stipulation of the parties, petitioner is entitled to a reduction of the deficiencies consistent with the Administrative Law Judge determination in Matter of Belding Heminway Co., Inc. (Division of Tax Appeals, September 9, 1988) (Finding of Fact "35").

S. Except as provided in Conclusion of Law "R", the petition of USV Pharmaceutical Corporation is denied. The notices of deficiency for 1978 and 1979 issued December 16, 1983 and the application of the investment tax credits against tax due for 1978, 1979 and 1980, as modified at conference (Finding of Fact "33[d]"), are otherwise sustained in full.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE