STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
STANDARD MANUFACTURING CO., INC.	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended July 31, 1980 and July 31, 1981.	: :	

Petitioner, Standard Manufacturing Co., Inc., 750 Second Avenue, North Troy, New York 12182, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended July 31, 1980 and July 31, 1981 (File No. 801415).

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on September 12, 1989 at 1:15 P.M., with all briefs to be submitted by February 7, 1990. Petitioner appeared by Lombardi, Reinhard, Walsh & Harrison, P.C. (Thomas J. Jordan, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUE

Whether the Division of Taxation may properly require petitioner, Standard Manufacturing Co., Inc., and its subsidiary, Caribbean Outerwear Corporation, to file combined franchise tax reports for the fiscal years ended July 31, 1980 and July 31, 1981.

FINDINGS OF FACT

On March 4, 1983 and June 10, 1983, the Division of Taxation issued separate statements of audit adjustment against petitioner, StandardManufacturing Co., Inc. (hereinafter, "Standard Manufacturing") for the fiscal years ended July 31, 1980 and July 31, 1981 (hereinafter, "1980" and "1981") showing corporation franchise tax deficiencies of $79,169.96

plus interest and $37,537.65 plus interest, respectively. Each statement contained the same explanation:

> "This estimated deficiency is for failure to file a New York State franchise tax report, Form CT-3 for Caribbean Outerwear Corp. and to include such income on the combined report of Standard Manufacturing Co. as required by our letters of September 21, 1978 and July 26, 1980."

On July 7, 1983 and August 18, 1983, the Division of Taxation issued separate notices of deficiency against Standard Manufacturing for 1980 and 1981 showing corporation franchise tax deficiencies of $79,169.96 plus interest and $37,537.65 plus interest, respectively.

Standard Manufacturing, a New York corporation, began business as a corporation in January 1961 although its predecessor had been in business since 1924. The company manufactures, buys and sells outerwear, in particular, jackets, windbreakers and so-called "tennis wear".

A review of petitioner's New York corporation franchise tax reports for each of the years at issue discloses that none of its three corporate officers, George Arakelian, President, John Arakelian, Vice-President nor Dorothy King, Secretary-Treasurer, received any salary and/or any other compensation from petitioner. Petitioner also reported negative "entire net income" for 1980 and 1981 of ($435,056.08) and ($538,071.80), respectively. Nonetheless, "end of year" total assets were reported for 1980 and 1981 of $15,359,844.54 and $14,261,985.82,[1] respectively, and the average fair market value of current liabilities for 1980 and 1981 were reported as $7,628,978.39 and $7,268,844.66, respectively.

In contrast to the lack of compensation shown paid to petitioner's officers on the New York reports, the respective schedules E of the forms 1120, U.S. corporation income tax returns for petitioner and its subsidiaries[2] that were attached to the New York reports, show

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[1]Petitioner incorrectly reported end of year assets of $8,371,261.36 on the first page of the report for 1981. It appears an error was made in transposing the correct figure from line 46 of Schedule E inside the report.

[2]Petitioner filed combined New York corporation franchise tax reports for each of the years at issue with only two of its subsidiaries, Standard Leasing of Troy, N.Y., Inc. and 750 Second Ave.

compensation of officers as follows:

	1980	1981
George Arakelian	144,184.03	131,628.72
John Arakelian	61,176.41	None
Dorothy King	141,820.17	88,003.94

Schedules attached to each of the Federal returns show that compensation of officers of $347,180.61 and $219,632.66 for 1980 and 1981, respectively, was paid by petitioner's subsididary, 750 Second Ave. Management Corp.

The Federal returns show negative Federal "taxable income" of ($846,824.28) and ($634,911.01) for 1980 and 1981, respectively. Further, petitioner's Federal returns show percentages of corporation stock owned as follows:

	Common	Preferred
George Arakelian	50%	
John Arakelian		100%
Dorothy King	50%	

George Arakelian, who has been president of Standard Manufacturing since 1965, testified that petitioner established Caribbean Outerwear Corporation (hereinafter "Caribbean") in 1968:

> "We needed to expand our business and that was one of the areas that we wanted to go and set up a manufacturing facility. We needed more production."

Caribbean (a Delaware corporation) is a wholly-owned subsidiary of Standard Manufacturing located in Yabucoa, Puerto Rico. In addition to the significant tax incentives for locating a company in Puerto Rico, there is a substantial labor savings incentive. Standard Manufacturing and Caribbean manufacture similar products, which entails the employment of approximately 150 and 200 sewing machine operators, respectively. On average, it appears that Standard Manufacturing's sewing machine operators are compensated at a rate approximately 35% more per hour than Caribbean's.

Petitioner conceded that it purchased, during each of the years at issue, more than 50

Management Corp. At places in the reports, 750 Second Ave. Management Corp. is described as 750 Second Ave. Realty Corp. There is no explanation in the record for this variance. Petitioner also included an additional subsidiary, Logan Manufacturing Co., Inc., in its federal corporation income tax returns. Logan is an apparel manufacturer located in Logan, West Virginia.

percent of the total product manufactured by Caribbean and that both corporations had the same persons on their respective boards of directors. As noted on Caribbean's Federal corporation income tax returns, George Arakelian, John Arakelian and Dorothy King served as Caribbean's officers as well, but no compensation was shown on Caribbean's tax returns. In fact, petitioner, by its representative, stipulated that "there are substantial intercorporate transactions" between Standard Manufacturing and Caribbean and admitted that the two corporations were part of a unitary business.

Nonetheless, George Arakelian testified that Caribbean was run as an independent business from Standard Manufacturing with separate managers and employees; that Standard Manufacturing provided no technical assistance or training to Caribbean; that there was no exchange of personnel or internal transfer of materials between the two companies; and that there was no financing of Caribbean's operation by Standard.

A review of the forms 1120, U.S. corporation income tax returns, of Caribbean for the years at issue show a financially successful operation:

	Fiscal Year Ending July 1, 1980	Fiscal Year Ending July 1, 1981
Gross receipts or sales	$6,087,991.66	$4,739,062.50
Total income	$1,548,836.32	$1,171,392.23
Taxable income	$1,297,105.24	$ 963,409.46
Total tax	None	None

The Internal Revenue Service audited the corporation tax returns of petitioner and Caribbean for the 1976 and 1977 fiscal years. Petitioner introduced into evidence a Form 4549-A, Income Tax Examination Changes (hereinafter, "revenue agent's report"), for these earlier years that shows an adjustment under Internal Revenue Code § 482 of the price of goods sold by Caribbean to Standard in order to reflect an arm's length price. The Office of International Operations of the Internal Revenue Service participated in this adjustment of the pricing of intercompany sales. The revenue agent's report notes:

> "Pricing of goods from Puerto Rican subsidiary to U.S. parent was adjusted to reflect an arm-length price under Code section 482, Rev. Proc. 63-10 and Mis

42G 166.[3] The results of this pricing adjustment for the years under audit are as follows:

7/31/73	$283,083
7/31/76	$ 22,481
7/31/77	$ 30,876"

Donald Shutt, a certified public accountant, who has been Standard Manufacturing's independent accountant for approximately 25 years testified that the adjustment to the pricing of sales by Caribbean to petitioner made by the IRS for the earlier years was a formula:

> "And the formula was to be a self-adjusting formula so that it could be used consistently over the subsequent years. So that each year the IRS wouldn't have to come in and audit the corporate records in order to establish a new price, new intercompany selling price."

The formula was cost of goods sold plus a 10 percent markup plus a labor savings factor of 35 percent. The specific calculation for the two earlier years under Federal audit was as follows:

	Fiscal Year Ending 7/31/76		Fiscal Year Ending 7/31/77	
Cost of Goods Sold	$2,956,047.00		$4,093,229.00	
Less Non-Productive Salaries	12,287.00		15,850.00	
Adjusted Cost of Goods Sold	$2,943,760.00		$4,077,379.00	
10% Mark-up		294,376.00		407,738.00
Labor Savings @35%		418,414.00		626,295.00
Total	712,790.00		1,034,033.00	
Intercompany transfer price	3,656,550.00		5,111,412.00	
Intercompany transfer price per return	3,679,031.00		5,142,288.00	
Sec. 482 Adjustment (Pricing)	$ 22,481.00		$ 30,876.00	

Donald Shutt testified that in preparing the tax returns for petitioner and Caribbean for the years at issue, and, in fact, all years subsequent to the IRS audit, he determined the intercompany transfer price by utilizing this so-called "cost plus" formula described above. He also testified that an analysis of (1) Caribbean's gross profit percentages and percentages of

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[3] It is unclear what this abbreviation refers to.

labor cost to cost of goods sold and (2) petitioner's gross profit percentages and percentages of labor to cost of goods sold show that the formula retained its economic validity. In particular, he gave his opinion that the labor savings adjustment of 35%[4] and the 10% mark-up remained a fair method to determine the pricing of products sold by Caribbean to petitioner. Mr. Shutt also opined that if petitioner is required to file a combined return with Caribbean, there would be a distortion of income in favor of New York:

> "(T)here are three factors in the apportionment rule, and those factors are sales, labor, and property and equipment....
>
> ...(L)abor is cheaper in Puerto Rico than in New York State. So, therefore, by using the labor factor, it distorts in New York State's favor the percentage of income earned in New York State.
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> Also, Puerto Rico has a distortion in regard to property and equipment because the Puerto Rican government provided the company with a factory building.
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> * * *
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> The factory building was provided by the Puerto Rican government at a relatively low rental value, which again distorts New York State's apportionment of income to New York State. So, therefore, I don't believe that combining these two corporations truly reflects New York State's taxable portion of income earned."

In addition to the adjustment of the pricing of goods sold by Caribbean to Standard Manufacturing, a review of the revenue agent's report also discloses that an adjustment was made by the Internal Revenue Service under IRC § 482 to set up a charge to the Puerto Rican subsidiary (Caribbean) for services performed on its behalf by Standard Manufacturing. These services included managerial, accounting, financial and other services. The report provided the following detailed calculation to show how charges to Caribbean of $125,464.00 for the fiscal

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[4]Earlier in the hearing, George Arakelian testified on direct examination that based upon his weekly review of the payroll records of petitioner and Caribbean, the difference of the labor costs and wage rates paid by petitioner as opposed to the same costs which are paid by Caribbean is 35%. It should be noted that this testimony was brought out by questions that could be described as leading. On cross-examination, Mr. Arakelian noted that "the cost of manufacturing, the direct labor that goes into the manufacture of the product is thirty-five percent less at Puerto Rico than it is at Troy." He later conceded that the 35% is not an exact figure, but an average one for 1980 and 1981, as well as for earlier and subsequent years. Although Mr. Arakelian's testimony with regard to the difference in labor costs of petitioner and Caribben seemed, to some extent, crafted, it does reinforce the testimony of Mr. Shutt.

year ended July 31, 1976 and $135,302.00 for the fiscal year ended July 31, 1977 for such services from petitioner were determined:

	Fiscal Year Ended 7/31/76	
Sales	Standard Manufacturing	$ 7,638,130.3_ [5]
	Logan Mfg. Co., Inc.	1,600,__9.61
	Caribbean	3,679,030.72
Total Sales		12,917,771.15
	Caribbean % of Sales	3,679,030.72 / 12,917,771.15 = 28.48%
	Expenses to be allocated	430,000[6]
	Applicable Percentage	28.48%
	Management Fee Allocation	122,464
	Charge for Computer and Delivery of Payroll	3,000
	Total Management Fee	$ 125,464.00
	Fiscal Year Ended 7/31/77	
Sales	Standard Manufacturing	$10,113,639.00
	Logan Mfg. Co., Inc.	2,507,339.00
	Caribbean	5,142,268.00
Total Sales		17,763,246.00
	Caribbean % of Sales	5,142,268 / 17,763,246 = 28.95%

[5] It is difficult to determine from the poor copy of the revenue agent's report in the record some of the digits on these calculations of the adjustment for management services, and the unreadable digits have been left blank.

[6] The expenses to be allocated in both calculations, as noted in the revenue agent's report, consisted of the "total expenses of 730 Second Ave. Management Corp. which is allocated among all the manufacturing members of the controlled group."

Expenses to be allocated	$ 457,000
Applicable percentage	28.95%
Management Fee	132,302
Change for Computer and Delivery of Payroll	3,000
Total Management Fee	$ 135,302.00

Petitioner at the hearing herein did not focus upon or address the adjustments made by the Internal Revenue Service for management fees, which in effect, decreased Caribbean's income and increased petitioner's income for the periods ended July 31, 1976 and July 31, 1977. There was no evidence introduced concerning whether similar adjustments would need to be made by petitioner for subsequent years other than the general testimony of George Arakelian that petitioner and Caribbean had separate managers and that petitioner provided no technical assistance or training to Caribbean, as noted in Finding of Fact "6", supra.

The Division of Taxation and petitioner have agreed that if it is determined that Standard Manufacturing is required to file a combined franchise tax report including Caribbean, the tax due shall be determined by a business allocation percentage (Tax Law § 210.3), and that the tax deficiencies shall be revised as follows:

Fiscal Year Ended	Deficiency
July 31, 1980	$24,125.77
July 31, 1981	$ 9,860.54

SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that it should not be required to file combined tax returns with its subsidiary, Caribbean, for 1980 and 1981, because a combined report was neither necessary to truly reflect income nor avoid distortion. Although petitioner conceded that it and Caribbean were part of a unitary business and that there were substantial intercompany transactions between the two, it argues that its New York income is more accurately reflected by its filing of a return without the inclusion of Caribbean. Petitioner contends that the cost-plus method of pricing the sale of goods from Caribbean to it, established by the IRS for the audited 1976 and 1977 tax years and utilized by petitioner in subsequent years, ensured that petitioner is not overstating the cost of purchasing goods from Caribbean. Finally, petitioner argues that it would end up paying a distorted amount of tax to New York if it is required to file combined returns with Caribbean, because the business allocation formula fails to take into consideration Caribbean's lower labor and property costs in Puerto Rico in comparison to petitioner's labor and property costs in New York.

The Division's position, as articulated by its auditor, seems to be that petitioner is required to file a combined return with Caribbean, because the old regulations, that were in effect during the years at issue, required combined returns. Petitioner and Caribbean constituted a unitary business and had substantial intercorporate transactions, and the issue of whether combined returns were required to avoid distortion of income was irrelevant under the applicable old regulations.

CONCLUSIONS OF LAW

A. Tax Law § 211.4 provides, in part, as follows:

> "In the discretion of the tax commission,[7] any taxpayer, which owns or controls 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...; provided, further, that no combined report covering any corporation not a taxpayer shall
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> be required unless the tax commission 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."

B. The regulations promulgated under Tax Law § 211.4 and effective for taxable years commencing on or after January 1, 1976, provided, in relevant part:

> "(a)...In deciding whether to permit or require combined reports the following two broad factors must be met:
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> (1) the corporations are in substance parts of a unitary business conducted by the entire group of corporations, and

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[7] Effective September 1, 1987, under Tax Law § 2026 references to the State Tax Commission in the Tax Law, in all instances other than in relation to the administration of the administrative hearing process, are deemed to refer to the Division of Taxation or Commissioner of Taxation and Finance.

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

(b) In deciding whether each 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:

(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 of the group.

The Tax Commission will consider a corporation to be 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 of a corporation's receipts are from any qualified activities." (20 NYCRR former 6-2.3.)

C. As noted in Finding of Fact "6", supra, petitioner has conceded that there were substantial intercorporate transactions between petitioner and Caribbean and that the two corporations were part of a unitary business. Simply stated, Caribbean was an expansion of Standard Manufacturing's business because Standard Manufacturing "needed more production" as noted by George Arakelian in his testimony. The Division argues that petitioner's case is, therefore, closed. Combined returns are properly required. It is difficult to understand how the Division can make this argument in light of the case law that requires a determination whether "under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income [citation omitted]" (Matter of Coleco Industries, Inc. v. State Tax Commn., 92 AD2d 1008, 1009, 461 NYS2d 462, 463, affd 59 NY2d 994, 466 NYS2d 682).

The Court of Appeals in Matter of Campbell Sales Company v. New York State Tax Commn. (68 NY2d 617, 505 NYS2d 54, cert denied 479 US 1088) muddied the waters, in its reversal of the Appellate Division's decision (Matter of Campbell Sales v. New York State Tax Commn., 111 AD2d 995, 490 NYS2d 313). The Court of Appeals in its brief decision determined that Campbell Sales Company and its parent corporation were required to file a combined franchise tax return because the corporations were part of a unitary business conducted by the entire group of corporations and had substantial intercorporate transactions. Emphasizing the earlier decision of the majority of a divided Court of Appeals (4-3) in Matter of Wurlitzer Co. v. State Tax Commn. (35 NY2d 100, 358 NYS2d 762) the Court noted that "'it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected' before the Commission may exercise that discretion and require combined reports because of intercompany transactions" (Matter of Campbell Sales v. NYS Tax Commn., supra, 505 NYS2d 54, 55). Judge Kaye, in a vigorous dissent, disagreed with the majority and noted that the finding of a unitary business and substantial intercorporate transactions was not enough:

> "Our 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." (Matter of Campbell Sales Co. v. State Tax Commn., supra, 505 NYS2d 54, 56.)

Interestingly, the Court of Appeals in its most recent decision addressing this issue affirmed the Appellate Division's decision that noted that Standard Manufacturing (the same petitioner as herein) and Caribbean were required to file a combined return for the fiscal years ended July 31, 1978 and July 31, 1979 based on a resolution of 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" (Matter of Standard Manufacturing Company, Inc. v. Tax Commn. of the State of New York, 114 AD2d 138, 498 NYS2d 724, 726, affd 69 NY2d 635, 511 NYS2d 229, appeal dismissed 481 US 1044). It should be noted that the Court of Appeals was unanimous in its affirmance and included Judge Kaye who had dissented in the earlier Matter of Campbell Sales Co. v. NYS Tax Commn. (supra). Even if the Court of Appeals by its affirmance cannot be said to have reversed sub rosa its decision in Matter of Campbell Sales Co. v. NYS Tax Commn. (supra), it has clearly moved in the direction of Judge Kaye's dissent in Matter of Campbell Sales Co. v. NYS Tax Commn. (supra).

D. The current regulations, effective for all taxable years ending on or after December 31, 1983, follow the case law described above. The Division may require or allow the filing of combined reports where the three conditions of the regulations have been met: (1) a stock ownership test (20 NYCRR 6-2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3).[8]

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[8]20 NYCRR 6-2.3, which sets forth the presumption of distortion if there are substanial intercorporate transactions between taxpayers, is not directly applicable herein because Caribbean, petitioner's Puerto Rican subsidiary, is a foreign (i.e., Delaware) corporation and not a taxpayer. Nonetheless, 20 NYCRR 6-2.5(a) incorporates 6-2.3 by reference:

> "(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 of more taxpayers included in the group because of
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> > (1) substantial intercorporate transactions (see subdivision (c) of section 6-2.3 of this Part); or
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> > (2) some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected."

Under this regulation, the Division of Taxation may require combined reports because of "substantial intercorporate transactions" as elaborated upon in subdivision (c) of section 6-2.3. (Effective September 1, 1987, under Tax Law § 2026, references to the State Tax Commission in the Tax Law, in all instances other than in relation to the administration of the administrative hearing process, are deemed to refer to the Division of Taxation or Commissioner of Taxation and Finance. Similarly, the reference to the Tax Commission in the above regulation should be deemed to refer to the Division of Taxation.) 20 NYCRR 6-2.3 permits the rebuttal of the presumption of distortion, and, in my opinion, this right to rebut is incorporated into 20 NYCRR 6-2.5(a) by reference. A contrary interpretation of the regulation, that would not permit a party to rebut the presumption merely because the subsidiary is a foreign corporation

The distortion of income test contained in 20 NYCRR 6-2.3(a) provides that the Division of Taxation "may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations."

E. It should be noted that the Tax Appeals Tribunal in its recent decision in Matter of Autotote Limited (Tax Appeals Tribunal, April 12, 1990) applied the Division's current regulations to an audit period that included a period that would have been covered by the old regulations. This retroactive application is reasonable especially in light of the fact that the old regulations were inadequate in light of the case law described, supra.

F. As a result, the matter at hand entails a determination whether petitioner has introduced sufficient evidence or proof to rebut the presumption that its income will be distorted if it reports on a separate basis. The presumption of distortion is properly made because of the substantial intercorporate transactions between petitioner and Caribbean.

This matter represents petitioner's second bite of the apple in its attempt to show that its income was not distorted by its filing separate from Caribbean. At the administrative level on its first time around, with regard to its fiscal years ended July 31, 1978 and July 31, 1979, petitioner introduced substantially more evidence concerning the management of Caribbean. A review of the administrative determination (Matter of Standard Manufacturing Co., Inc., State Tax Commission, May 2, 1984) shows that petitioner introduced much evidence concerning the

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and not a New York taxpayer, is not acceptable given the case law described above and, in particular, Matter of Standard Manufacturing Company, Inc. v. Tax Commn. of the State of New York, 114 AD2d 138, 498 NYS2d 724, affd 69 NY2d 635, 511 NYS2d 229, appeal dismissed 481 US 1044, supra.

Further, mention should be made that the Division of Taxation has not specifically contended that a combined return was required herein because of the second basis noted above in the regulation. Although it does seem that the first basis (i.e. substantial intercorporate transactions) is subsumed by this second basis.

duties of Sixto Gonzalez who was hired to be Caribbean's "chief operating officer" in Puerto Rico. This time around, petitioner has conceded that it and Caribbean are part of a unitary business and had substantial intercompany transactions and limited its proof to a showing that petitioner purchased goods from Caribbean at an arm's-length price.

G. It is concluded that the cost-plus formula utilized by the Internal Revenue Service to adjust the pricing of goods purchased by petitioner from Caribbean during 1976 and 1977 was reasonable. It should be noted that there is no one arm's length price between a buyer or seller. Rather, there is a continuum of prices, beginning at the lowest price at which a seller would sell and ending at the highest price at which a buyer would buy, that constitute arm's length prices. The prices calculated by the IRS fall within this continuum of prices and can be said to be arm's length prices. Further, the credible testimony of petitioner's accountant has established that petitioner applied the same cost-plus formula in calculating the pricing of goods purchased by petitioner from Caribbean during the years at issue.

Rev Proc 63-10 (1963-1 CB 490), which provides guidelines to be followed in the application of IRC § 482 in cases involving the allocation of income and expenses between U.S. companies and their manufacturing affiliates in Puerto Rico, notes, in part as follows:

> "1. Directly Applicable Independent Prices.
> The best evidence of the applicable arm's length price is the price paid in transactions between independent buyers and sellers for the same product under similar circumstances. Thus, if the island affiliate produces a standardized product which is sold independently in the United States by other firms, the applicable arm's length price allowed the island affiliate will be the delivered cost to an independent buyer.... In this connection, the independent price is a generally prevailing price.... The independent price must accurately reflect the cost the mainland affiliate would have incurred had it obtained the identical product at prevailing prices on the open market.
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> * * *
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> 2. Independent Prices for Similar Products.
> The problem of applying section 482 of the Code is more difficult as a practical matter when directly applicable independent prices are not available. However, when a product manufactured in Puerto Rico and sold only to a mainland affiliate differs only slightly from other products bought and sold by independent firms, an arm's length price for the island affiliate may be determined by adjusting these independent prices to take account of such minor differences as are present.

> 3. No Independent Prices.
> In some cases, similar products may not be sold independently so that information regarding independent prices for even similar products is not available. In this event, so long as the product in question represents a type which is manufactured in the United States..., the price which would have been necessary to induce an independent U.S. firm to produce in the United States the product in question for the mainland affiliate in the quantities involved constitutes the best approximation of the applicable arm's length price.... That price normally would be those costs which would be incurred in the United States if the activities performed by the island affiliate were performed in the United States rather than in Puerto Rico plus a rate of profit which is representative for that type of United States manufacturing activities."

In sum, petitioner has offered satisfactory proof that the type of calculation described above in the IRS Revenue Procedure, for the situation where there are no independent prices, was utilized for the years at issue. Consequently, an arm's length pricing was utilized during 1980 and 1981 for the sale of goods from Caribbean to petitioner (cf., Digital Equipment Corporation, State Tax Commission, June 28, 1985).

H. However, what is troubling with regard to petitioner's presentation this second time around is its failure to focus upon or address the adjustment made by the Internal Revenue Service for management fees. During 1976 and 1977, the IRS, as noted in Finding of Fact "11", supra, in effect, decreased Caribbean's income and increased petitioner's income by $125,464.00 and $135,302.00, respectively, in order to account for management services that had not been previously charged to Caribbean. As noted in Finding of Fact "11", supra, the IRS outlined a reasonable methodology for the calculation of management expenses to be allocated to Caribbean, which, in effect, would reduce petitioner's expenses. Although George Arakelian, petitioner's president testified that petitioner provided no technical assistance or training to Caribbean, he also noted that he reviewed Caribbean's payroll on a weekly basis. There can be little doubt that ultimate control over Caribbean rested with George Arakelian and his two other fellow officers. They were the common directors of Caribbean and petitioner and had ultimate control over both entities.

As noted in Finding of Fact "5", supra, officer compensation was paid during the years at issue through petitioner's subsidiary, 750 Second Ave. Management Corp., which did file a combined New York return with petitioner. Some portion of this compensation must be allocated to Caribbean. Consequently, the Division of Taxation is directed to determine an allocation by utilizing the methodology utilized by the IRS for the earlier years as described in Finding of Fact "11", supra, which will, in effect, reduce petitioner's expenses for the years at issue. In conclusion, although the Division of Taxation may not require petitioner and its subsidiary, Caribbean Outerwear Corporation, to file combined franchise tax reports for the fiscal years ended July 31, 1980 and July 31, 1981, in determining petitioner's income for New York tax purposes for such years, an allocation of management expenses as described above must also be made.[9]

I. The petition of Standard Manufacturing Co., Inc. is granted to the extent indicated in Conclusion of Law "H", supra, but in all other respects is denied.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE

[9] Because petitioner's tax reports, as filed, calculated tax due by using the alternative base of business and investment capital allocated to New York in lieu of entire net income, there may be no deficiency due to petitioner's failure to allocate the so-called "management fees".