STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
SEARS, ROEBUCK AND CO.	:	DETERMINATION DTA NO. 801732
for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended January 31, 1981 and December 31, 1981.	:	

Petitioner Sears, Roebuck and Co., Sears Tower, Department 970, 41st Floor, Chicago, Illinois 60684 filed a petition for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended January 31, 1981 and December 31, 1981.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on February 6, 1991 at 9:15 A.M., with all briefs to be filed by October 15, 1991. Petitioner submitted its brief on May 6, 1991. The Division of Taxation submitted its brief on August 26, 1991 and petitioner's reply was presented on October 11, 1991. A request by petitioner to submit a supplemental statement of position was granted by the Administrative Law Judge on February 14, 1992. A letter in lieu of brief was submitted by petitioner on March 11, 1992 and the Division of Taxation's letter in lieu of brief was received by the Division of Tax Appeals on April 29, 1992. Petitioner appeared by Morrison & Foerster (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).

ISSUES

I. Whether the Division of Taxation properly determined that petitioner, Sears, Roebuck and Co., and its wholly-owned subsidiary, Sears Roebuck Acceptance Corporation, were engaged in a unitary business for the purpose of requiring the companies to file a combined

report.

II. Whether the Division of Taxation properly required Sears Roebuck Acceptance Corporation to file a franchise tax report on a combined basis with its parent corporation, Sears, Roebuck and Co., for the fiscal years at issue.

III. If combined reporting of Sears, Roebuck and Co. and Sears Roebuck Acceptance Corporation is required, whether the apportionment formula should be adjusted to include (a) Sears Roebuck Acceptance Corporation's intangible property in the property factor; and (b) Sears Roebuck Acceptance Corporation's receipts in the receipts factor.

FINDINGS OF FACT

The parties to this matter stipulated and agreed that, for the purpose of this case, certain facts and exhibits may be accepted as truthful information. Where references are made to exhibits, excerpts from such exhibits or the summarization of the contents of the exhibit will be provided in conjunction with the appropriate stipulated fact. The facts so stipulated are as follows:

Sears, Roebuck and Co. ("Sears") is the petitioner in this case. The years involved are the taxable years ended January 31, 1981 and December 31, 1981, and the tax is the New York corporation franchise tax, Article 9-A of the New York Tax Law. The issues in dispute are: (1) whether the Division of Taxation ("Division") of the New York State Department of Taxation and Finance may require petitioner to file reports for the years involved on a combined basis with its subsidiary, Sears Roebuck Acceptance Corporation ("SRAC"); and, if so, whether (2) in computing the property ratio of the three-factor business allocation formula, SRAC's intangible property should have been included; and (3) in computing the receipts ratio of the three-factor formula, SRAC's interest income should have been included.

Sears is, and was during the years involved, a nationwide retailing company. At all times relevant, its main office and principal place of business was in Chicago, Illinois, and it did business in every state in the United States, and the District of Columbia.

SRAC is a wholly-owned subsidiary of Sears. It was incorporated in 1956 under the

laws of the State of Delaware and its only office is, and at all times relevant was, located in Delaware. During the years at issue, SRAC had no office in New York, did no business in New York and was not subject to the New York franchise tax. It has never filed returns in New York and has never been assessed any tax by New York.

SRAC's principal business is, and at all times relevant was, to obtain funds by (a) direct placement of commercial paper notes in the open market, (b) demand borrowings under agreements with bank trust departments, and (c) private placement with bank trust departments of variable interest rate notes collectible after 13 months. SRAC also obtained funds through the sale of medium-term notes on a directly-placed basis with institutional investors. SRAC loans funds to Sears and receives in return Sears promissory notes. The rate charged by SRAC at all relevant times was derived by a formula intended to fix SRAC's ratio of earnings to fixed charges at 1.5 to 1. In the ordinary course, SRAC did not purchase Sears' accounts receivable, except for certain isolated sales on the last day of each fiscal year involved.

SRAC is not involved in Sears' provision of charge accounts and credit to customers, which has always been handled by Sears' credit department. The sale of Sears' accounts receivable, primarily to banks, has always been handled by Sears' treasurer's department, and no sales were made to SRAC other than the ones referred to in Finding of Fact "4" above.

SRAC was created and maintained as an entity separate from Sears for a number of valid business purposes, as set forth in the affidavit of Robert F. Gurnee, the former president and chief executive officer of SRAC.[1] Because it is separately organized, SRAC is able to borrow at the lowest interest rates available to direct issuers of commercial paper. Sears cannot borrow at those low rates. SRAC's debt-to-capital-funds- employed ratio is much more favorable than Sears'. General mercantile corporations ordinarily invest a portion of their funds in plant and inventory, while the funds of financial corporations are typically invested in self-liquidating, relatively short-term intangible assets. Therefore, general corporations generally

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[1]The pertinent facts established by Mr. Gurnee's affidavit which was attached as an exhibit to the stipulation are stated herein.

face a borrowing limit of $1.00 or less of senior debt to each $1.00 of equity, while financial corporations, whose assets are more readily marketable, are able to borrow $4.00 or $5.00 of senior debt for each $1.00 of equity or subordinated debt. During 1966 through 1975, SRAC's debt-to-capital-funds-employed ratio ranged from 4.99 to 1 to 3.11 to 1. SRAC, because of its financial structure, consistently meets the restrictions placed by many states upon the types of investments that can be made by certain organizations such as banks, insurance companies, pension funds, trust officers, and state entities, and often is able to place its commercial paper with these organizations.

SRAC was created as a finance company separate from Sears for legitimate business purposes. Among other things, the creation of SRAC enabled Sears to raise necessary funds at the lowest possible rates in the open market. In addition, the market would view SRAC as a more creditworthy operation due to its separate capitalization. The reasons for the creation of SRAC as a separate finance company are summarized in the affidavit of H. Russell Fraser. Mr. Fraser's employment included the position of Vice President of Standard and Poor's Corporate Finance Department where he was responsible for all corporate bond and commercial paper ratings, and the position of Vice President and Manager of the Fixed Income Research Department where he was required to keep investors advised as to the credit worthiness of the major issuers of senior securities in the capital markets. Although Mr. Fraser's affidavit was prepared in 1977, he stated that he was fully familiar with the operation of SRAC and Sears, and made his statement based on that knowledge. An excerpt from Mr. Fraser's affidavit follows:

> "The creation of SRAC occurred at a point in time in financial history when the only sizable participants in the commercial paper market were financial companies who sold their paper directly. The commercial paper market competed with instruments of the commercial banking system and Treasury bills. While a few major industrial corporations were participating in the commercial paper market through what was called the dealer market, the extent this market was being used at that time was relatively small and inefficient, and in no way was the dealer market capable of financing the quantity of funds SRAC required.
>
> "The decision to form SRAC in 1956 was based on sound business judgment and was consistent with what other major money market borrowers were doing, whether they were financing consumer receivables or whether they were financing

> receivables from large capital goods manufacturers as automobiles, farm machinery equipment and/or receivables related to a variety of other capital goods. Sears chose to establish SRAC because it afforded a means to capture for Sears' shareholders banking profits which otherwise would have been earned by the commercial banking fraternity. This method of using a finance company placed the business of economically obtaining short-term funds in a separate entity specifically designed to perform this function. The separate organization of this activity was and still is required to enable such a large undertaking to be successful."

SRAC is, and was at all times relevant, one of the largest financial companies in the United States. It competes for capital resources directly with commercial banks, with other large financial companies, such as General Motors Acceptance Corporation and Ford Motor Credit, and with Treasury bills and Federal agency short-term notes. In terms of total assets, SRAC is, and at all times relevant was, the fourth or fifth largest non-bank finance company in the United States. During the years involved, SRAC's loans receivable averaged over $6.4 billion.

For the fiscal year ended January 31, 1981, Sears originally filed its New York corporate franchise tax return on a separate basis. At all times relevant, and by this action, Sears protested and continues to protest the correctness of a combination. Nonetheless, Sears filed its franchise tax return on a combined basis with SRAC for the fiscal year ended December 31, 1981, and computed its liability as described below.

SRAC holds large amounts of intangible property. That property alone generates SRAC's income. In computing the New York combined return for the fiscal year ended December 31, 1981, SRAC included its intangible property in the denominator of the reported combined property factor.

SRAC's only receipts were its interest receipts.

On the basis of its combined report, Sears paid $1,328,069.00 in franchise taxes for the year ended December 31, 1981.

Sears then filed an amended return for the taxable year ended January 31, 1981, reporting on a combined basis with SRAC, and including SRAC's intangible property in the denominator of the property factor, which is used in the computation of the business allocation

percentage. The business allocation percentage is used to apportion entire net income to New York. With its amended return, Sears paid additional franchise taxes, for a total of $1,003,488.00 in franchise taxes for the year ended January 31, 1981.

The Division contends that (a) Sears should file combined reports with SRAC for the years involved, and (b) SRAC's intangible property should not be included in the combined returns' business allocation percentage factors. The Division recomputed the three-factor formula by removing SRAC's intangible property from the property factors. Notices of deficiency were timely issued in the amounts of $132,234.00 for the year ended January 31, 1981, and $171,699.00 for the year ended December 31, 1981. The notices issued for the periods ended December 31, 1981 and January 31, 1981 included interest of $67,674.00 and $71,425.00 for total assessments of $239,373.00 and $203,659.00, respectively.

During the years involved, more than 99.9% of SRAC's property was intangible property, all of which was located in Delaware. In computing the property ratio, the Division did not include this intangible property owned by SRAC in the denominators of the property factors used to compute Sears' business allocation percentages.

During the years involved, SRAC's only receipts for purposes of computing the business allocation percentage were its interest receipts. In computing the receipts ratios, the Division did not include the SRAC receipts in the denominators of the receipts factors used to compute Sears' business allocation percentages.

In Sears, Roebuck and Company v. Franchise Tax Board (Cal Sup Ct, December 14, 1983), settled on appeal, the California Superior Court held that, for the period February 1, 1967 through January 31, 1973, the Franchise Tax Board could properly require a combination of the incomes of Sears and SRAC, but the apportionment formula used for purposes of computing Sears' California franchise tax must attribute SRAC's income to its "true income producing sources", and must include SRAC's intangible property and interest income in the combined returns' factor.

If Sears prevails and is not required to file combined reports with SRAC for the years

involved, Sears would be entitled to reductions in tax due of $429,393.00 for the year ended January 31, 1981 and $854,113.00 for the year ended December 31, 1981. Thus, Sears would not be liable for deficiencies and would be entitled to refunds of $297,159.00 for the year ended January 31, 1981 and $682,414.00 for the year ended December 31, 1981. The calculations submitted by petitioner resulting in the reduction of tax due are presented below:

Reduction in Assessment Due to Reversal of the Combination of SRAC

SEARS, ROEBUCK AND CO.
NEW YORK FRANCHISE TAX
FISCAL PERIODS ENDED 1/31/81 and 12/31/81

	Fiscal Period Ended 1/31/81		12/31/81	
Business allocation percentage:	New York	Everywhere	New York	Everywhere
Property ratio - per audit		.036187		.036556
Payroll - per audit	151,820,760	3,858,724,021	137,848,269	3,563,865,675
SRAC Payroll		(794,219)		(732,956)
	151,820,760	3,857,929,802	137,848,269	3,563,132,719
Payroll ratio		.039353		.038687
Sales ratio - per audit		.047552		.048687
		.047552		.048687
Total percentages		.170644		.172617
Revised business allocation percentage (A)		.042661		.043154
Business income - per audit		200,660,533		277,784,379
Effect of reversing SRAC combination		(99,491,750)		(297,354,189)
Revised business income - excluding SRAC (B)		101,168,783		(19,569,810)
Revised allocation business income (A) x (B)		4,315,961		(844,515)
Investment income per audit	35,394,233		30,833,896	
SRAC investment income	(10,107,421)		(7,483,958)	
	25,286,812		23,349,938	
Investment allocation percentage - per audit	.004939		.005352	
		124,892		124,969
Revised allocated income		4,440,853		(719,546)
Less: Optional depreciation - per audit		175,097		98,541
Revised taxable New York income		~~4,265,756~~		~~(818,087)~~
Revised tax @ 10% (C)		~~426,576~~		~~-0-~~
Alternative tax on allocated capital:				
Business capital per return	5,385,826,736		4,988,144,485	
Business ratio	.042661		.043154	
Revised allocated business capital	229,764,754		215,258,387	
Tax @ .00178				

(11/12 in 12/31/81) (D)	~~408,981~~	~~351,230~~
Revised tax on greater of (C) or (D)	426,576	351,230
Subsidiary capital tax per audit	279,753	294,425
Revised total tax - reversing SRAC combination	706,329	645,655
Tax per assessment	1,135,722	1,499,768
Reduction in assessment due to reversal of SRAC combination	~~429,393~~	~~854,113~~

If Sears is required to file combined reports with SRAC, and SRAC's intangible property and interest income are included in the factors, Sears will be entitled to a reduction in tax due of $114,978.00 for the year ended January 31, 1981, for a total tax of $1,020,744.00, and a reduction in tax due of $169,115.00 for the year ended December 31, 1981, for a total tax of $1,330,653.00. Thus, the proposed deficiencies would be reduced to $17,256.00 for the year ended January 31, 1981 and $2,584.00 for the year ended December 31, 1981. The second set of calculations prepared by petitioner resulting in the reduction of tax due are shown below:

Reduction in Assessment Due to Inclusion of Proper SRAC Factors

SEARS, ROEBUCK AND CO.
NEW YORK FRANCHISE TAX
FISCAL PERIODS ENDED 1/31/81 and 12/31/81

	Fiscal Period Ended			
	1/31/81		12/31/81	
Business allocation percentage:	New York	Everywhere	New York	Everywhere
Property per audit	230,478,146	6,368,999,489	243,089,515	6,649,736,276
SRAC property (primarily receivables)		6,134,055,837		6,617,954,454
	230,478,146	12,503,055,326	243,089,,515	13,267,690,730
Property ratio		.018434		.018322
Payroll ratio - per audit		.039345		.038679
Receipts - per audit	856,336,360	18,008,559,851	888,955,048	18,258,571,193
SRAC interest income		1,034,802,426		1,224,430,249
	856,336,360	19,043,362,277	888,955,048	19,483,001,442
Receipts ratio		.044968		.045627
		.044968		.045627
Total percentages		.147715		.148255
Revised business allocation percentage		.036929		.037064
Business income - per audit		200,660,533		277,784,379
Revised allocated business income		7,410,193		10,295,800
Allocated investment income - per audit	174,812		165,023	
Revised allocated income		7,585,005		10,460,823
Less: Optional depreciation - per audit	175,097		98,541	
Revised taxable New York income		7,409,908		10,362,282

Revised tax @ 10%	740,991	1,036,228
Subsidiary capital tax - per audit	279,753	294,425
Revised total tax reflecting proper SRAC factors	1,020,744	1,330,653
Tax per assessment	1,135,722	1,499,768
Reduction in assessment due to inclusion of proper SRAC factors	114,978	169,115

On January 17, 1985, petitioner timely filed a Petition for Redetermination of Deficiencies and Claims for Refund.

On April 28, 1987, petitioner timely filed a Perfected Petition.

On September 9, 1987, the Division filed its Answer to the Perfected Petition.

Concurrent with the submission of petitioner's post-hearing brief, petitioner submitted proposed findings of fact. After careful review of the record and consideration of the testimony given, the following proposed findings of fact have been accepted and are incorporated in Findings of Fact "23" through "31".

SRAC was located in Delaware to take advantage of the State's proximity to the east coast financial markets, the quality of the local labor pool, and the established body of Delaware corporate law.

Finding of Fact "4" refers to the rate charged by SRAC as being derived by a formula intended to fix SRAC's ratio of earnings to fixed charges at 1.5 to 1. This rate was originally chosen because it was, in SRAC's early days, the rate required by statute to qualify SRAC's commercial paper as permitted investments for New York insurance companies. The 1.5-to-1 ratio later became an industry standard, and by maintaining that rate SRAC was able to compete effectively in the commercial paper market, and attract investments not only from insurance companies but from the many other large companies and institutions that adopted the 1.5-to-1 ratio. During the years in issue, the 1.5-to-1 ratio generated an average loan rate paid by Sears to SRAC of 15.78%, which was nearly identical to the prime rate during these years.

During the years in issue, SRAC had 45 to 48 employees located in Delaware, who managed and operated its business, entirely independent of the Sears operation in Chicago. SRAC had its own computer system and outside legal counsel. Sears never provided SRAC

with clients lists, suppliers, contacts, suggestions for sources of money or loan guarantees. There were no common officers or directors. SRAC's business was dynamic and volatile, and dependent on an intimate knowledge of the paper market. It was not, and could not have been, managed by anyone at Sears, 900 miles away in Chicago.

If SRAC had had excess funds and lent them to another borrower with a credit rating similar to that of Sears, the loan would have had to have been at the same rate as the loans to Sears, in order to generate the same 1.5-to-1 ratio. If Sears had borrowed from another finance company, it would have had to pay the same rate.

The operations of finance companies like SRAC are similar to the operation of banks, except that finance companies do not accept deposits and are therefore not as heavily regulated. Their activities and borrowing ability is the same as that of banks. If SRAC had not been formed, Sears would have borrowed from a bank instead, and the income earned by SRAC would have been earned by a bank. That income could never have been earned by Sears if it and SRAC were one operation.

Upon audit, the Division required Sears to file a combined report covering SRAC. The Division decided that Sears and SRAC were operating a unitary business because SRAC borrowed funds and relent them to Sears. It made no analysis of whether Sears and SRAC were "unitary" under the factors discussed in a series of Supreme Court cases, ASARCO, Inc. v. Idaho State Tax Commn. (458 US 307 [1982]); F. W. Woolworth Co. v. Taxation & Revenue Dept. of New Mexico (458 US 354 [1982]); Container Corp. of America v. Franchise Tax Board (463 US 159 [1983]). It made no finding of functional integration, centralized management or economies of scale.

The Division also determined that the relationship between Sears and SRAC was not arm's length, because SRAC was "guaranteed a profit" by the use of the 1.5-to-1 ratio in setting the loan rate to Sears. The Division did not know or investigate whether the 1.5-to-1 ratio was an arm's-length rate, standard in the commercial paper industry.

In computing the combined report it deemed necessary, the Division combined Sears'

income with SRAC income and applied the business allocation percentage, but gave no factor representation to SRAC in that percentage. Instead, it excluded SRAC's receipts from the receipts factor and SRAC's intangible property from the property factor. As a result, the combination of SRAC and Sears' income is apportioned to New York almost entirely based upon Sears' factors. If SRAC were to move its entire operation to New York, the combined tax would hardly change under the method used by the Division.

Relating to Finding of Fact "17", petitioner proposes that the California law relied upon by the Franchise Tax Board to require combination of the incomes of Sears and SRAC can be differentiated from New York Tax Law inasmuch as it does not contain New York's "distortion" requirement for mandatory combined reports.

The New York State Audit

In February 1983, a corporation tax field audit of Sears for the fiscal periods in issue was commenced by an auditor of the Division's Chicago District Office. The Division offered the testimony of the team leader,[2] Steven Carnevale, who assumed responsibility for the case after the auditor originally assigned to the matter left State service. Mr. Carnevale testified that he participated in that field audit as a team leader, reviewed documents that were submitted and assisted with the preparation of schedules. He testified that the audit group reviewed the New York State tax returns as filed, the Federal tax returns for the same periods, and supporting documentation for those returns. The audit was performed at petitioner's headquarters in Chicago.

Mr. Carnevale testified that, based on his participation in the field audit, he learned that the business of Sears was as a retail merchandiser of a broad line of products sold domestically through retail outlets and catalog stores. He further acknowledged that one of the subsidiary corporations of Sears was SRAC, a 100% wholly-owned subsidiary corporation. His testimony

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[2]Since the testimony of the team leader was the only testimony offered by a person involved with the audit from the Division, any references hereinafter to "the auditor" refer to the testimony of the team leader.

included information pertaining to SRAC as a finance company that borrowed funds from various sources primarily through the issuance of commercial paper and subsequently loaned such funds solely to Sears via the issuance of promissory notes.

As a result of a review of the books and records, there was a conclusion drawn that a combined New York State Franchise Tax Report should be mandated which included Sears and SRAC. The basis for such determination, Mr. Carnevale testified, was the applicable law and regulations pertaining to combined reporting, which included the following four items: an ownership test, a corporation test, a unitary business test, and an intercompany activity test. When questioned about the unitary business requirement, Mr. Carnevale indicated that such a test could be met in several ways, including sales to the same customers, one corporation financing the sale of the other corporation's products, and one corporation selling substantially to the other corporation. He stated that as a result of those factual indices a combined report would be necessary since it indicated the nature of a unitary business.

The auditor's testimony revealed that SRAC was not a taxpayer for New York purposes and, when further questioned about his conclusion concerning the unitary business requirement, Mr. Carnevale testified that it was based on the fact that SRAC borrowed funds and relent those funds solely to Sears. Having concluded it was proper to require mandatory combination of petitioner and SRAC, the auditor then proceeded to testify as to the mathematical mechanics of the combination. He outlined the mechanics as including a computation of the income of each individual company on a separate basis, i.e., the computation of entire net income, the addition of such entire net income, applying any appropriate intercompany eliminations, to result in a combined income. The combined income is then apportioned by a three-factor formula comprised of property, receipts and wages, both inside and outside New York State. This formula is referred to as the business allocation percentage.

The auditor's testimony revealed that there was no dispute that SRAC was a separate entity with its own substantial earnings in the State of Delaware. The auditor was questioned with regard to whether there were any findings of other than arm's-length transactions and his

response was that there were several items identified that could be construed as failing to meet an arm's-length standard. The first item he noted was that SRAC was guaranteed a profit by the use of the 1.5-to-1 factor charged to petitioner for the funds loaned to the parent corporation. Although reference was made to the fact that such a ratio was custom in the industry, the auditor expressed a lack of knowledge to draw such a conclusion. He was aware, however, that SRAC as a separate entity had the ability to borrow more funds and at a lower rate than could petitioner. The auditor, however, was unaware whether the borrowing could be accomplished without the guarantee of petitioner.

When the auditor was questioned further about the basis for finding a unitary relationship between the corporations, having previously cited the fact that SRAC borrows funds and relends them solely to Sears, he also indicated that the conclusion that the corporations have a unitary relationship was based on an examination of the internal relationship between the corporations and a determination of whether SRAC could exist on its own. In the opinion of the audit team, it could not. Mr. Carnevale's testimony made clear that no analysis was made of whether Sears and SRAC were unitary under factors discussed in various Supreme Court cases. The Division did not attempt to determine whether there was centralized management, functional integration or economies of scale between such corporations. The auditor testified that there was integration between the corporations in the sense that the lending was substantial and SRAC loaned funds solely to Sears for the operation of a portion of its business. However, upon clarification of the term "functional integration", as the Supreme Court has applied it, the auditor testified there was no functional integration between SRAC and Sears.

The Division's representations, by the testimony of Mr. Carnevale, clearly supported petitioner's proposed finding of fact "28".

Petitioner presented the testimony of Robert Gurnee who held numerous key positions with SRAC from 1958 through the end of 1980. Between 1972 and 1980 Mr. Gurnee held the position of president and chief executive officer of SRAC, essentially running SRAC at its

Delaware location. In January 1981, he was appointed vice-president and corporate treasurer of petitioner and moved to Chicago to assume his new position. Mr. Gurnee described the full function of SRAC as having consisted of borrowing funds in the open market through a variety of means. He stated that in the commercial paper market, borrowing money from demand master note agreements with bank trust departments, master note borrowings on a 13-month basis with bank trust departments, and the occasional sale of medium term notes was a summarization of the practice of SRAC's business. Having obtained funds in the open market at competitive rates, the funds were then loaned to Sears. Mr. Gurnee described SRAC as having been formed to fulfill a need in 1956. He joined the company in 1958 and at that time Sears was financing its receivables by selling them to banks, and in its normal course of operations would have approximately $900,000,000.00 worth of receivables out to banks. Since Sears was in a position of reaching legal lending limits and showed concern about its future and growth in terms of demands for operating capital, the finance company evolved. He testified that the commercial paper market had grown over the years, and presently is the largest single market for providing capital to corporations. The concept of a finance company was so attractive because of the self-liquidating nature of the receivables. SRAC and like companies could borrow up to eight-to-one, i.e., for each dollar of its capital base it could borrow up to eight dollars. However, with a non-financial company, since such a significant portion of its capital is invested in real property and inventory, the ability to borrow is significantly more restricted. In fact, a non-financial company would have been allowed to borrow only approximately 60% of its equity base. In addition, Mr. Gurnee testified that the rates obtainable by such corporations differed. This self-liquidating nature of receivables of the finance company gave it an ability to get into the direct issue commercial paper market and tap such market at a much better rate than a retailer or non-financial company.

Historically, a New York State law existed whereby a finance company was required to maintain a level of 1½ times fixed charges. Simply, if SRAC was to meet such requirement and was paying 4% interest, it had to collect income from Sears at a rate of at least 6%. Over time,

the 1½ times fixed charges became an industry standard. Mr. Gurnee testified that as compared to funds Sears could have obtained in the open market, petitioner was paying a competitive but comparable rate. For example, in 1980 the average prime rate which Sears would have had to pay was approximately 15.80%. The average return to SRAC for money loaned to Sears during that same period was 15.78%.

Mr. Gurnee's testimony also revealed that SRAC was placed in Delaware as a strategic location where it was considered to be in the center of a very stable labor market, as well as in a state with a well developed body of corporate law. During the years in issue, SRAC employed between 45 and 48 persons and had its own computer operations. There were no common officers between Sears and SRAC.

Mr. Gurnee was asked to explain the interaction between Sears and SRAC vis-a-vis the exchange of funds. He indicated that Sears has a vast cash management system, with 1700 to 1800 units reporting in each day. Sears determines a daily net position (funds received less funds disbursed) and maintains contact with SRAC to report the position for the purpose of meeting maturities and borrowing additional funds for operating capital. The notes exchanged between Sears and SRAC are maintained in increments of billions of dollars and the balance fluctuates each day. But essentially the contact between the companies is solely between Sears' treasurer's department and the cash manager of SRAC. Mr. Gurnee's testimony also supported the explanation provided by petitioner regarding the beneficial position of a financial company due to its self-liquidating assets with respect to its borrowing power and the preferential rates it could obtain.

Mr. Gurnee's testimony was followed by that of Ashwinpaul Sondhi, an associate professor of accounting at New York University whose credentials include a PhD in accounting. His teaching and research are in the areas of accounting and financial analysis. He has spent a great deal of time studying finance companies, both captive and independent, and has published numerous articles about the attributes of finance companies, why they exist, the extent of their debt capacity, and the relationship between the parent and the finance company. Professor

Sondhi reviewed the financial statements of Sears and SRAC, the stipulation of facts as submitted in this matter and the financial statements of approximately 20 companies that are either independent or captive finance companies, along with the contractual agreements with their lenders.

Professor Sondhi's testimony reconfirmed that SRAC and similar finance companies are established for the sound business reason that capital markets do not allow non-financial companies to borrow generally more than up to 60% of their equity due to the risk of their operations. Where a subsidiary corporation is established as a finance company it is designed to ensure that its cash flows and net worth can be made both liquid and safe to the extent that financial markets allow for borrowing of up to eight times equity. Professor Sondhi testified to these facts on the basis of his review of actual borrowings on behalf of the previously mentioned 20 finance companies during the years in issue. He compared the activities of a finance subsidiary such as SRAC to that of a bank with the exception of two critical differences: (1) finance companies do not accept deposits and (2) they are not regulated to the same extent by the Federal Reserve or by state regulating agencies. He noted that one of the most important characteristics of the finance subsidiaries that allow for a favorable borrowing situation is the fact that its assets are self-liquidating.

Professor Sondhi also discussed the provision of the Insurance Law which requires insurance companies to invest only in financial companies earning at least 1½ times their fixed costs. He stated that the ratio is not unique to SRAC and is used by both captive and independent finance companies. He concluded that had SRAC lent funds to an unrelated corporation having a credit rating equivalent to Sears', the rate would have had to meet the same ratio. Likewise, if Sears were borrowing from another finance company, the same or similar amounts would have been charged. For purposes of the discussion, he explained that a captive finance company is one that does at least 70% of its business with the parent company, such as in this case. He compared a captive finance company to an independent one which does not conduct a majority of its transactions with a parent company. The 20 companies reviewed and

the analysis performed involved a variety of captive and independent finance companies.

Professor Sondhi's testimony and a prepared written report submitted into evidence discussed the historical New York Insurance Law requirement referred to previously. The law designated debt securities of subsidiary financial companies as eligible investments when the subsidiary financial company maintains a prescribed ratio of earnings to fixed operating expenses. Professor Sondhi reports that because of this ratio financial markets view the risk involved in doing business with financial subsidiaries as significantly lower, thus allowing them greater access to capital and lower interest and financing expenses. These and other resulting financing benefits cannot be duplicated by non-financial companies which are denied access to financial markets because they lack such characteristics. Professor Sondhi believes that combination of SRAC and petitioner ignores the fact that, from an economic perspective, if SRAC had not been created, and its business activities were assumed by its parent, the income SRAC produces would not exist. Sears would not have been able to produce the income to the extent produced by SRAC due to the factors unique to financial corporations and treating such income as if it had been earned by Sears overstates the income of petitioner and distorts the portion of combined income actually attributable to Sears' activities.

Petitioner offered the testimony of Richard Genetelli, a partner of the certified public accounting firm of Coopers & Lybrand. He has maintained a position with the State and Local Tax Division of the firm for more than 10 years and he was qualified as an expert in accounting and economics. Mr. Genetelli reviewed the tax returns filed by petitioner, as well as the audit report and the stipulation of facts offered into evidence. He concluded that SRAC and Sears should not be combined because the transactions between the corporations are on an arm's-length basis. He does not believe distortion results by the separate company filing of these corporations and stated that a combined report is not necessary to correct any distortion. Furthermore, Mr. Genetelli established in his written report also submitted into evidence that there is an inherent distortion in combining mercantile and financial companies. He explains by saying that a finance company generates income from intangible assets, whereas a mercantile

company generates income from the sale of tangible personal property. As a result, the mercantile company uses a normal apportionment formula consisting of property, payroll and receipts in apportioning income to New York State. However, application of the normal three-factor formula to a financial company does not consider certain factors which are relevant to the company in generating income. Thus, such a combination would result in distortion of income.

SUMMARY OF PETITIONER'S POSITION

Petitioner sets forth as its primary argument that Sears and SRAC should not be combined, and submits that the basis for its assertion is (1) the relationship between Sears and SRAC is not unitary, and (2) a combined report is not necessary to properly reflect its New York State income. In dealing with the concept of a unitary business relationship, petitioner acknowledges that the requirement of "unitariness" exists due to the constitutional limit on the reach of a State's power to include out-of-state income in its apportionment formula. Even if the income of a group of domestic corporations is generated by interstate as well as intrastate activities, it may be fairly apportioned to a given state for tax purposes on the basis of this concept (citing pertinent authority). Petitioner refers to the Supreme Court holdings that the "'lynchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principal'." Thus the concept of a unitary business relationship is key in determining whether a state may apply an apportionment formula to a taxpayer's income, including such income earned by other related corporations.

Petitioner acknowledges that New York State Tax Law and Regulations give guidance for a determination of the unitary business relationship. However, petitioner asserts the regulation must be interpreted in light of constitutional mandates and policy set forth in a series of Supreme Court cases. To determine whether a business is unitary, the Supreme Court has directed a state to examine the "'functional integration, centralization of management, and economies of scale' that exists between a company and its subsidiaries" (citing relevant authority). Petitioner claims where functional integration is found a unitary business exists, but where companies have little functional integration such as where a subsidiary operates on an

independent basis with its own accounting department and financial staff, outside counsel, independent personnel, its own internal training program and obtains its own financing from sources other than the parent, a unitary business has been held not to exist. Petitioner maintains that not only do none of these unitary business factors exist between Sears and SRAC, but the Division did not inquire as to aspects of the independent or autonomous operation of the companies, or whether any functional integration or centralized management existed. Petitioner believes the Division's determination as to the unitary nature of the business relationship began and ended with the conclusion that SRAC borrowed funds and relent those funds only to Sears. Petitioner attempted to develop a record to show that Sears and SRAC each conducted its own self-contained businesses with independent personnel, separate accounting departments, and each having its own outside legal counsel. SRAC was managed in Delaware by Robert Gurnee, who testified on behalf of petitioner, and employees under his direction and control. Mr. Gurnee testified that due to the volatility of the commercial paper market, as well as the complexity of the transactions involved, it would have been impossible for anyone in Chicago to manage SRAC's business in Delaware, and in fact this was not the practice of petitioner. Petitioner asserts that the only factor relied upon by the Division to point to integration is the lending of funds by SRAC to Sears. These loans however do not establish the level of integration set forth in the Supreme Court cases. Petitioner claims many companies have an exclusive financing arrangement with one finance company which does not rise to the level of a unitary relationship under New York law.

Petitioner next advances the argument that even if a unitary relationship exists between Sears and SRAC, combined reporting may not be mandated because separate reports filed for the years in issue did not distort Sears' income. Petitioner cites to numerous pertinent authorities holding that each taxpayer should file a separate return unless the result distorts its income, in which case a combined report may be permitted or required. Petitioner asserts that the cases held that while the existence of substantial intercorporate transactions is sufficient to allow the Division to propose filing on a combined basis in the first instance, the taxpayer then

has the opportunity to show that filing on a combined basis is not necessary to properly reflect tax liability. Furthermore, petitioner asserts that the case law has expressly rejected the notion that an irrebutable presumption of distortion arises from the existence of substantial intercorporate transactions. Thus, the propriety of mandatory combination must be evaluated by whether petitioner introduces sufficient evidence to show that its income was properly reflected by separate reports despite the existence of substantial intercorporate transactions. Along this line, petitioner introduced substantial evidence to show that loans from SRAC to Sears were made at arm's-length market rates. Petitioner relies on numerous cases which have recognized that proof of arm's-length pricing or competitive prices establish that a combined report is not required to accurately reflect income. Mr. Gurnee's testimony initially established that SRAC created a return on its loans equal to 1½ times its interest expense. He testified that Sears paid SRAC what it would have had to pay other independent financial institutions, including banks. He characterized the relationship between Sears and SRAC during the years in issue as an arm's-length relationship on the basis of both their manner of operations and their separate operational functions, as well as on the arm's-length market rate charged for the function of lending.

Petitioner's final argument is that if combined reports between these two corporations are mandated, an adjustment must be made to include in the allocation formula the receipts and the intangible property of SRAC. Petitioner claims that the Division's proposed combination of Sears and SRAC results in distortion because no representation has been given by the Division to either SRAC's receipts or the assets that generate substantially all of SRAC's income, i.e., its intangible property. Petitioner maintains that application of the usual three-factor formula to the combined income of Sears and SRAC results in a gross distortion. Petitioner sets forth the distortion as follows: over 99% of SRAC's property that earns income is intangible and thus its tangible property amounts to less than 1% of its total assets. Since New York's standard business allocation formula double weights sales and gives equal weight to payroll and property, the law attributes one-fourth of income to tangible property. By excluding all of

SRAC's intangible property, the Division assumes that one-fourth of SRAC's income is generated by less than 1% of its capital assets, resulting in an obvious distortion of the income attributable to New York.

Petitioner also discusses the element of distortion from two other points of view: (1) by comparing income apportioned to New York to income apportioned to Delaware; and (2) by comparing SRAC separate income with Sears separate income. Petitioner argues that despite the fact that SRAC has all of its operations in Delaware, New York's formula apportions virtually nothing to Delaware and almost all its income to New York. Thus, SRAC's income is being taxed at virtually the same rate that would be applied if it were operating entirely in New York State. Petitioner cites to case law which has allowed a variation of the three-factor formula to account for the income of a financial business under a very similar factual situation. Petitioner asserts that New York Tax Law § 210.8 permits such variance from the usual three-factor formula where such formula does not accurately represent the extent of the taxpayer's business. The court in one matter found that there was such a disproportionate apportionment of income to a particular state that it bore no appropriate relationship to economic realities. Petitioner claims, similarly, under New York's mandatory combination apportionment approach SRAC's income is being taxed without factor representation and is out of proportion to economic reality. Petitioner contends that, in 1987, the Division delineated its own policy with regard to an allocation formula and stated that, "under appropriate circumstances the tax commission will now consider using its authority under section 210.8 of the Tax Law on a case-by-case basis", citing a Technical Services Bureau Memorandum.

Petitioner also relies on the guidance of the California Superior Court decision involving these parties which, though settled on appeal, determined that the combined income of Sears and SRAC could not be accurately presented without considering SRAC's intangible income. An excerpt from such decision follows:

> "SRAC is plainly the sole source of its own income. It is a financial corporation with its own financial factors which are separate from the mercantile factors of Sears. It is physically located in the state of Delaware. The nature of SRAC's financial business requires that the Board use a formula of apportionment that

> attributes a financial corporation's income to its true income producing sources. Thus it must include a measure of SRAC's intangible property (loans outstanding) and interest income." (Citation omitted.)

Petitioner believes that if mandatory combined reporting is concluded with respect to these corporations, in order to avoid a violation of the constitutional prohibition against taxing income over which a state has no jurisdiction, the Division must adapt its formula to reflect SRAC's intangible assets and receipts.

Mr. Genetelli also provided testimony to support petitioner's assertion that unacceptable distortion results if Sears and SRAC are combined without an adjustment to the allocation formula. He concludes that (1) if Sears and SRAC are combined, the property factor should be modified to include SRAC's intangible property, and (2) the receipts factor should be modified to include SRAC's interest income in the receipts factor. Mr. Genetelli's written report set forth a comparison of the apportionment factors used by the Division as compared to apportionment factors under an alternative combined method as he suggests would avoid distortion. The comparative calculations are set forth below:

APPORTIONMENT FACTORS USED BY NEW YORK
FYE 1/31/81

FACTOR DESCRIPTION	SEARS FACTOR	+	SRAC FACTOR	=	COMBINED FACTOR	RATIO %
NEW YORK TANGIBLE PROPERTY	230,478,146	+	-0-	=	230,478,146	3.6187
TOTAL TANGIBLE PROPERTY	6,368,999,489		-0-		6,368,999,489	
NEW YORK PAYROLL	151,820,760	+	-0-	=	151,820,760	3.9345
TOTAL PAYROLL	3,857,929,802		794,219		3,858,724,021	
NEW YORK SALES	856,336,360	+	-0-	=	856,336,360	4.7552
TOTAL SALES	18,008,559,581		-0-		18,008,559,851	

ADDITIONAL RECEIPTS FACTOR 4.7552%

TOTAL NEW YORK FACTORS

~~17.0636%~~

AVERAGE FACTORS ~~4.2659%~~

APPORTIONMENT FACTORS USED BY NEW YORK
FYE 12/31/81

FACTOR DESCRIPTION	SEARS FACTOR	+	SRAC FACTOR	=	COMBINED FACTOR	RATIO %
NEW YORK TANGIBLE PROPERTY	243,089,515	+	-0-	=	243,089,515	3.6556
TOTAL TANGIBLE PROPERTY	6,649,736,276		-0-		6,649,736,276	
NEW YORK PAYROLL	137,848,269	+	-0-	=	137,848,269	3.8679
TOTAL PAYROLL	3,563,132,719		732,956		3,563,865,675	
NEW YORK SALES	888,955,048	+	-0-	=	888,955,048	4.8687
TOTAL SALES	18,258,571,193		-0-		18,258,571,193	

ADDITIONAL RECEIPTS FACTOR 4.8687%

TOTAL NEW YORK FACTORS
~~17.2609%~~

AVERAGE FACTORS ~~4.3152%~~

APPORTIONMENT FACTORS UNDER
ALTERNATIVE COMBINED METHOD
FYE 1/31/81

FACTOR DESCRIPTION	SEARS FACTOR	+	SRAC FACTOR	=	COMBINED FACTOR	RATIO %
NEW YORK TANGIBLE PROPERTY	230,478,146	+	-0-			
TOTAL TANGIBLE PROPERTY	6,368,999,489		1,096,102			
					230,478,146	1.8434
					12,503,055,326	
NEW YORK INTANGIBLE PROPERTY	-0-					

TOTAL 6,132,959,735 __|
INTANGIBLE
PROPERTY

NEW YORK
PAYROLL 151,820,760 + -0- = 151,820,760 3.9345
TOTAL 3,857,929,802 794,219 3,858,724,021
PAYROLL

NEW YORK SALES
PLUS INTEREST
INCOME 856,336,360 + -0- = 856,336,360 4.4968
TOTAL 18,008,559,851 1,034,802,426 19,043,362,277
NEW YORK SALES
PLUS INTEREST
INCOME

ADDITIONAL RECEIPTS FACTOR 4.4968%

TOTAL NEW YORK FACTORS
~~14.7715%~~

AVERAGE FACTORS ~~3.6929%~~

APPORTIONMENT FACTORS UNDER
ALTERNATIVE COMBINED METHOD
FYE 12/31/81

FACTOR DESCRIPTION	SEARS FACTOR	+	SRAC FACTOR	=	COMBINED FACTOR	RATIO %
NEW YORK TANGIBLE PROPERTY	243,089,515	+	-0-	|		
TOTAL TANGIBLE PROPERTY	6,649,736,276		1,046,327	|		
					243,089,515	1.8322
				|	13,267,690,730	
NEW YORK INTANGIBLE PROPERTY			-0-	|		
TOTAL INTANGIBLE PROPERTY			6,616,908,127	__|		
NEW YORK PAYROLL	137,848,269	+	-0-	=	137,848,269	3.8679
TOTAL PAYROLL	3,563,132,719		732,956		3,563,865,675	
NEW YORK SALES PLUS INTEREST						

INCOME	888,955,048	+ -0-	= 888,955,048	4.5627
TOTAL	18,258,571,193	1,224,430,247	19,483,001,440	
NEW YORK SALES PLUS INTEREST INCOME				

ADDITIONAL RECEIPTS FACTOR 4.5627%

TOTAL NEW YORK FACTORS
~~14.8255%~~

AVERAGE FACTORS ~~3.7064%~~

Mr. Genetelli's testimony indicates that without such adjustment to the apportionment formula distortion occurs. For example, where SRAC's intangible property is not reflected in the apportionment formula employed by the Division, all of SRAC's income is being attributed to New York based on Sears' factors. It is his belief that, to the extent a combined report is mandated, consideration must be given to the financial factors of SRAC. In fact, Mr. Genetelli testified that it was his understanding in all other states where petitioner has agreed to or is required to file a combined report it has been done with factor representation as suggested herein.

Petitioner pointed out that, through the testimony of Mr. Genetelli, the "everywhere receipts factor" for SRAC was zero due to the fact that there was an intercorporate elimination between the two companies. Mr. Genetelli testified that, under the alternative method, his proposal would be not to make such intercompany elimination for receipts.

Petitioner then presented the testimony of James Buresh, the Director of Federal, State and local taxes for Sears in Chicago. Mr. Buresh has been with petitioner's tax department since 1970 and was intimately familiar with the California Superior Court decision and the ensuing settlement. He indicated that as a part of the settlement the parties agreed upon what was known as a pre-apportionment formula. The intent was to try to identify income belonging to SRAC and separately identify income belonging to Sears and apportion the combined income of what was the mercantile operation to California. The result was that certain SRAC income was not taxed by California if not attributable to the state.

SUMMARY OF THE DIVISION'S POSITION

With regard to the issue of whether the corporations are involved in a unitary business relationship, it is the Division's position that since SRAC is responsible for financing a substantial portion of Sears' sales through the daily securing of funds which Sears used to finance its retail operations, SRAC and Sears are engaged in a unitary business. As a result, it is the Division's position that franchise tax reports filed by petitioner on a combined basis with SRAC will more accurately reflect petitioner's in-state activity, the income attributable to that in-state activity and petitioner's franchise tax liability for the periods in issue.

The Division acknowledges that the requirement that corporations which the Division seeks to combine be engaged in a "unitary business" is not a statutory criteria, but appears, however, in the franchise tax regulations at former section 6-2.3(b) and current regulation 6-2.2(b). The Division notes that section 6-2.2(b)(1) denominates as one activity to be considered whether one of the corporations to be included in a combined report finances the sales of other corporations in the group. The Division argues that clearly SRAC is substantially, if not directly, involved in financing the sales of Sears and is responsible for generating the majority of Sears' financial operating requirements through its sale of commercial paper.

The Division submits it is an error to focus exclusively on the operations of SRAC in obtaining financing for Sears when determining whether the corporations are engaged in a unitary business. The Division believes that such limited attention to the details of SRAC's commercial paper transactions ignores the purpose for which the captive finance subsidiary was established and the significant role which SRAC plays in accomplishing the objectives of petitioner's retail merchandising operations. The Division cites to pertinent case law and states that certain facts are to be examined which explicate the relationship between the corporations to be combined. Some of the factors reviewed by the courts are the sources of profit and loss between the subject entities, the extent and nature of intercorporate transactions, the generation of income by and between entities, and the extent of integration of operations between the corporations. The Division notes that the Tax Appeals Tribunal, in holding whether a

corporation was engaged in a unitary business, stated that factors used in determining whether the same exists are almost identical to transactions considered in a determination of whether there are substantial intercorporate transactions.

The Division identified an exchange of value between the two corporations. The Division points out that there are substantial intercorporate transactions between the corporations since all of the funds which SRAC obtains as a result of its commercial paper transactions are loaned only to its parent. Such loans enable petitioner to operate and maintain its retail merchandising enterprise and it is established that Sears could not obtain the same financing on its own, either in the same amounts or by terms as favorable. The Division believes these facts establish that SRAC does not operate independently of its relationship with Sears and that, as such, Sears and SRAC are engaged in a unitary business.

The Division next asserts that it is appropriate for it to require Sears to continue to file franchise tax reports for the periods in issue on a combined basis with its financial subsidiary, SRAC. The corporations are united by ownership, have between themselves substantial intercorporate transactions and are engaged in the unitary business of the retail sale of merchandise. Thus, the Division argues a combined report will more accurately reflect the activities of the group within New York State. Along this line, the Division asserts that the terms of SRAC's agreements with its lenders do not establish that reporting on a separate basis more properly reflects the group's New York activity, income or franchise tax liability. The Division acknowledges petitioner's argument that the promissory note transactions between itself and SRAC were accomplished at an arm's-length price. However, the Division submits that petitioner has not overcome the presumption that reports filed on a separate basis do not accurately reflect the group's income or franchise tax liability. The Division explains it is neither a statutory nor regulatory condition precedent that it find entire net income or petitioner's tax liability distorted in order to exercise the discretion to require tax reports on a combined basis. Further, the Division is not required to affirmatively identify distortion before mandating combination and, it asserts, under strict statutory analysis, it has properly required

combination of petitioner with its wholly-owned subsidiary since there were substantial intercorporate transactions between the entities. The Division concedes, however, that the regulations and case law have established that more is required for mandatory or permissive combination than unity of ownership and unqualified intercorporate transactions. The Division believes that, to be consistent with statutory interpretation, by both regulation and in the cases, it must be assumed that the status of distortion is a situation where entire net income and/or franchise tax liability is inaccurately reflected. The Division submits that distortion is not a condition precedent, but rather is at most a presumption which arises from the facts of the intercorporate relationship between the entities to be combined. Whether this presumption is sustained or rebutted is a question of fact. The Division concludes that petitioner has not overcome the presumption that the New York State franchise tax liability is inaccurately reflected when Sears files reports on an individual basis and does not include items of income attributable to its subsidiary, SRAC.

On the final point of adjustment to the apportionment formula, the Division asserts that petitioner is not entitled to adjust the property factor of the Sears group combined business allocation percentage to include the value of certain intangible assets. The Division asserts that such adjustments are not appropriate and are not supported by either the facts of this proceeding or by relevant statute and regulation. Similarly, the Division argues there is no authority for precluding the intercompany elimination of receipts which SRAC receives from Sears. Such adjustment would be contrary to the statutory intent and to the specific regulatory provisions governing intercorporate eliminations.

The Division acknowledges that adjustments to the business allocation percentage which deviate from the statutory formula may be made only with the consent of the Commissioner. The purpose of a discretionary adjustment to the business allocation percentage is to fairly and accurately reflect entire net income attributable to New York. The Division asserts that the discretionary adjustment requested by petitioner will not result in an accurate and/or fair attribution of the combined group's income to New York State and, thus, the proposed

adjustment is not appropriate. The Division claims that combined entire net income against which the combined business allocation percentage is applied is an accurate reflection of the income generated by the unitary group. If Sears is permitted a receipts factor adjustment which reverses the intercorporate receipts elimination, the income of the group will not be accurately reflected. In addition, to include the intangibles in the property factor of the combined business allocation percentage necessarily dilutes the group's allocated entire net income. The adjusted combined business allocation percentage, as applied, would result in attribution of less income to New York than Sears' in-state business activities required. The Division asserts there is no authority for such a discretionary adjustment since it would not ensure that the income allocable to New York State was in fact being attributed.

CONCLUSIONS OF LAW

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

> "In the discretion of the tax commission,[3] 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 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."

B. The following corporation franchise tax regulations promulgated by the former State Tax Commission on August 31, 1976, applicable to tax years beginning on or after January 1, 1976, were in effect during the period in issue and 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

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[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.

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;

"(2) substantially all of the capital stock of the taxpayer is owned or controlled, either directly or indirectly, by other corporations which are to be included in the combined report;

"(3) substantially all of the capital stock of the taxpayer and substantially all of the capital stock of the other corporations which are to be included in the combined report are owned or controlled, either directly or indirectly, by the same interests.

* * *

"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]."

C. The regulations were amended by new provisions filed November 30, 1983 effective for all taxable years ending on or after December 31, 1983, 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

"(ii) substantially all of the capital stock of the taxpayer is owned or controlled, either directly or indirectly, by other corporations which are to be included in the combined report; or

"(iii) substantially all of the capital stock of the taxpayer and substantially all of the capital stock of the other corporations which are to be included in the combined report are owned or controlled, either directly or indirectly, by the same interests.

* * *

"(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. (For rules for requiring a corporation which is not a taxpayer to be included in a combined report, see subdivision [a] of section 6-2.5 of this Part.) 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. 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 each corporation have substantial intercorporate transactions with one other corporation or with a combined or combinable group of corporations. [Example omitted.]

* * *

"6-2.5 Corporations not required or permitted 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]."

20 NYCRR 6-2.5 was not changed in any significant way by the promulgation of the 1983 regulations. Thus, whether the 1976 or 1983 regulations are applied in the instant matter is not of any consequence. Though the regulations in effect during the periods in issue, i.e., the 1976 regulations, are correctly applied, the similarity between the two versions for this purpose makes the issue academic.

D. The facts of this case do not present a clear, straightforward view of a unitary business relationship. The regulations at 20 NYCRR former 6-2.3 give some guidance to determine whether a corporation is part of a unitary business. It states that the Division will consider whether the activities in which a corporation engages are related to the activities of another corporation, if for instance one is financing the sales of the other. Other factors are suggested to be considered, none of which apply in this case. There appears to be no dispute that, in some fashion, SRAC is financing the sales and business operations of its parent. However, with the body of case law developed by the Supreme Court the discussion cannot end here. The Tax Appeals Tribunal, in a matter addressing the unitary business relationship between two corporations, took the position that the regulations dealing with this concept "comport with the three indicia of a unitary business enunciated by the Supreme Court, i.e., functional integration, centralization of management and economies of scale" (Matter of USV Pharmaceutical Corp., Tax Appeals Tribunal, July 16, 1992). Petitioner asserts that the Supreme Court cases dealing with such concepts have placed a greater emphasis on the total integration of the companies rather than focusing on a particular series of transactions. The Division agrees that it is an error to focus exclusively on the operations of SRAC in obtaining financing for Sears, because such limited attention ignores the purposes for which SRAC was created.

The Supreme Court has held that the use of formula apportionment is limited as a constitutional matter to situations where the intercompany economics would be difficult to measure on a separate basis due to the existence of a functionally integrated business. The Court explains its principles as follows:

> "The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities -- even on a proportional basis -- unless there is a '"minimal connection" or "nexus" between the interstate activities and the taxing State, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise."' (Citations omitted.) At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported 'unitary business' unless at least some part of it is conducted in the State (citations omitted). It also requires that there be some bond of ownership or control uniting the purported 'unitary business.' (Citations omitted.)
>
> "In addition, the principles we have quoted require that the out-of-state activities of the purported 'unitary business' be related in some concrete way to the in-state activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement -- beyond the mere flow of funds arising out of a passive investment or a distinct business operation -- which renders formula apportionment a reasonable method of taxation." (Container Corp. v. Franchise Tax Bd., 463 US 159, 165-166, 77 L Ed2d 545, 553-554.)

E. Petitioner does not dispute that there is an exchange of value between the two corporations and, in fact, shows that the income earned by SRAC would not have been earned to the same extent by Sears due to the differing borrowing rates and availability of funds. Petitioner presented a vast amount of testimony by numerous people who were either intimately involved with the operations of SRAC or had obtained sufficient knowledge to testify to the borrowing operations, the rates obtainable and the benefits of the existence of SRAC, and compared such information to a situation where Sears may have had to borrow in the open market. The value exchanged between the two corporations was clearly a tangible one. However, the criteria set forth by the Supreme Court indicate that some inherent value should exist between the two corporations that is incapable of measurement or identification. The Division identified an exchange of value between the two corporations by pointing out that there are substantial intercorporate transactions between them, since all the funds obtained by SRAC are loaned only to its parent. The Division claims that it enables petitioner to maintain its retail merchandising operations and states that Sears could not obtain the same financing on its own, either in the same amounts or by terms as favorable and that these facts establish that SRAC does not operate independent of its relationship with Sears and, as such, they are engaged in a unitary business. Petitioner supplied credible testimony that established that Sears

could, in fact, obtain financing through a non-related finance company with terms essentially equal to those it arranged with SRAC, if forced to seek the same in the open market. The testimony also unequivocally established that SRAC was completely autonomous from Sears and could have lent equally to other merchandising operations with a similar rating. Although SRAC played an important role in loaning funds to its parent and, as such, contributed to petitioner's corporate expansion, the value is not immeasurable or incapable of identification.

F. The Tax Appeals Tribunal, in assessing whether permissive combined reporting should be allowed in the Matter of Autotote, Ltd. (Tax Appeals Tribunal, April 12, 1990), observed that the unitary business test and the distortion of income test involve interrelated factors. The Tribunal, in comparing 20 NYCRR 6-2.2(b) with 20 NYCRR 6-2.3(c), stated that the activities considered by the Division in determining whether a unitary business exists are almost identical to the transactions considered to determine whether there are substantial intercorporate transactions. In Autotote, the Tribunal concluded that a unitary business was established where a parent loaned money to the petitioner subsidiary and obtained outside financing for the subsidiary's business activities. In that case, the petitioner was engaged in the design, manufacture and marketing of automated wagering equipment and the parent, not involved in such business operations, financed the petitioner's business operations. One key difference between Autotote and the case herein is that the parent relied entirely on the subsidiary's facilities and personnel to perform their functions and, as a result, complete integration of the operations was found to exist. In this matter the autonomy of the two was clearly outlined. In another case, functional integration was identified in the operation of a central buying division which resulted in more favorable prices being obtained by an Illinois corporation operating wholesale distributing houses in numerous states (see, Butler Bros. v. McColgan, 315 US 501, 86 L Ed 991). Such interrelationship at the core of the operation contributed significantly to such finding.

G. The Supreme Court in Mobil Oil Corp. v. Commissioner of Taxes of Vermont (445 US 425, 63 L Ed2d 510) observed that separate geographic accounting, "while it purports to

isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale" (id. at 438). The Court observed no effort on behalf of Mobil to demonstrate that the operations of the corporations under scrutiny were distinct in any business or economic sense from sales activities in the state where taxation was sought. Proof of a discrete business enterprise was found to be lacking. The Supreme Court applied these principles in its next decision in this area in Exxon Corp. v. Wisconsin Dept. of Revenue (447 US 207, 65 L Ed2d 66). Exxon was a vertically integrated petroleum company which explored, produced, refined and marketed petroleum and related products. The State of Wisconsin sought to apportion and tax Exxon's income from non-marketing activities even though the activities which took place in Wisconsin were limited to marketing. The Wisconsin Tax Commission found that Exxon's three main functional operating departments were separate unitary businesses, only later to be overturned by a finding that they were all part of a single unitary business. Review by the Supreme Court led the Court to conclude that the decisive concept in Exxon was that of a unitary business, repeating Mobil's dicta that "[t]he 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principle'" (id. at 223). The Court examined the underlying economic realities and it concluded that to exclude certain income from apportionment "[t]he income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise'" (id.). Exxon's Coordination and Services Management office "provided many essential corporate services for the entire company." Likewise, "sales were facilitated through the use of a uniform credit card system, uniform packaging, brand names, and promotional displays, all run from the national headquarters" (id. at 224). Considering these and other factors, the Court found that Exxon was "a highly integrated business which benefits from an umbrella of centralized management and controlled interaction" and had failed to show that the three departments were discrete business enterprises.

H. Looking back on its principles set forth in Mobil and Exxon, the Supreme Court faced

F. W. Woolworth Co. v. Taxation and Revenue Dept. of the State of New Mexico (458 US 354, 73 L Ed2d 819), to determine whether the "factors of profitability", i.e., functional integration, centralization of management and economies of sale, existed. The State of New Mexico sought to tax a portion of dividends that a parent corporation engaging in retailing throughout the United States (including New Mexico), whose principal place of business was New York, received from foreign subsidiaries doing no business in New Mexico. The U.S. Supreme Court reversed the Supreme Court of New Mexico holding that New Mexico's taxation of dividends received from foreign subsidiaries violated the due process clause of the Fourteenth Amendment since each subsidiary operated a discrete business enterprise absent any umbrella of centralized management and controlled interaction, since the parent's operations were not functionally integrated with its subsidiaries, and since the subsidiaries were not part of a unitary business. The Court in Woolworth differentiated the business of retailing from the "'highly integrated business' of locating, processing and marketing a resource such as petroleum" where the Court previously found a unitary business to exist (id. at 364). The Court noted that the evidence actually showed that no phase of the subsidiary's business was integrated with the parent's. The Court documented the absence of central control by its emphasis on autonomous and independent functions such as store site selection, advertising, accounting, choice of financial staff, and separate outside legal counsel. It was further noted that there was "no centralized purchasing, manufacturing or warehousing of merchandise" (id. at 365). Next, the Court considered whether there existed centralization of management or achievement of other economies of scale. It observed that each of the subsidiaries in that case "operated as a distinct business enterprise at the level of fulltime management" (id. at 366). Woolworth did not rotate or exchange personnel. There was no central training program for management. Each subsidiary determined its own retailing policies such as size and location of retail stores, market conditions and the mix of items to be offered for sale. Woolworth had "no department . . . devoted to overseeing the foreign subsidiary operations" (id. at 367). There was "no policy of the parent that all of the managers of all the operations get together periodically to

discuss the overall Woolworth operations" (id. at 368). The managerial link between the companies included approval of major financial decisions by the parent and communication between upper-level management. In spite of an occasional oversight by the parent, the Court found no integration of the business activities or centralization of management. The Court further differentiated the Woolworth facts from those in Exxon where the management office in Exxon provided for long-range company planning, development of financial policy and procedures, maintenance of the accounting system, attainment of legal counsel, public relations and other essential corporate services. It was concluded that the companies did not have integration such that one's "'stable' operation is important to the other's 'full utilization' of capacity" (id. at 370).

"Economies of scale" is one of the "factors of profitability" assessed by the Supreme Court in determining whether a unitary relationship exists. However, the cases seem to reach their conclusions before this concept is afforded much discussion. One economist describes economies of scale in relation to the interdependence between companies (see generally, McLure, Defining a Unitary Business: An Economist's View, The State Corporation Income Tax: Issues in Worldwide Unitary Combination [1984]). He states that "such economies [of scale] exist when output can be increased by some given multiple . . . by increasing all inputs by a common, but smaller multiple . . ." (id. at 96). This concept is often applied to the maintenance of inventories or the use of common storage facilities. The key idea is that two corporations acting together maintain an optimum level of some aspect of the business at a lower cost than if each did so separately, such that it would be impossible to determine the separate profits of such affiliates. If such interrelationship were found to exist, it would be difficult to conclude that the companies were not part of a unitary business. No evidence of economies of scale appeared in this matter.

I. This matter clearly falls much closer to the facts enunciated in Woolworth than Exxon or Mobil. The record developed by petitioner herein reflects the fact that Sears and SRAC conducted their own fully self-contained businesses. The corporations had their own

accounting departments, financial staff and outside counsel, no central personnel training program, no rotation or exchange of personnel and maintained separate responsibility for the development and training of their own management. They did not utilize a central purchasing function or facilitate sales through a uniform credit system or uniform packaging. The "managerial links" as described by the testimony were necessary and commonplace for the type of financial transactions that took place. There was no more of an interrelation betwen Sears and SRAC than Sears would have had with a non-related lender.

The Division made no analysis of whether the corporations herein are "unitary" as discussed in the various Supreme Court cases. There was no inquiry as to whether the businesses were operated as one and whether they were under the direction of a common group of people. There was no finding of functional integration, centralization of management or economies of scale. The Division relied upon the fact that SRAC had a guaranteed market given its relationship with Sears. This was an insufficient analysis of whether a unitary business relationship existed between the two. The loans themselves do not establish the functional integration required by due process considerations. As the facts were presented herein, Sears and SRAC each operate a discrete business enterprise with a "notable absence of any 'umbrella of centralized management and controlled interaction'" (Exxon Corp. v. Wisconson Dept. of Revenue, supra at 224). Petitioner has established that Sears and SRAC are not engaged in a unitary business relationship.

J. Assuming arguendo that SRAC and Sears are engaged in a unitary business relationship, the issue that follows involves the well-debated "distortion" requirement. "Distortion" remains undefined by statute or regulation. The regulations provide that the Division cannot require a nontaxpayer to file a combined report unless it finds that certain ownership and unitary business tests are met and that inclusion is necessary to properly reflect the tax liability of the taxpayers because of the existence of either substantial intercorporate transactions or specifically defined agreements. The Division has attempted in similar matters to argue a position which essentially places New York under a classic unitary tax jurisdiction

rather than a limited unitary tax jurisdiction. It would require nontaxpayer combination where a unitary business is found to exist without the resolution of the distortion issue. The Tax Appeals Tribunal, in its February 6, 1992 decision of Matter of Standard Manufacturing Company, Inc. (hereinafter "Standard II"), rejected the position taken by the Division that the question of income distortion is not applicable where the Division seeks to require combination between a nontaxpayer and a taxpayer corporation on the basis of substantial intercorporate transactions between them.

Standard II involved a New York corporation and a Delaware subsidiary corporation located in Puerto Rico. The taxpayer conceded there were substantial intercorporate transactions between it and the subsidiary and that the two corporations were part of a unitary business. The taxpayer argued, however, that it should not be required to file combined returns with the subsidiary since a combined report was neither necessary to truly reflect income nor avoid distortion. The Division took the position in that matter that the question of distortion is not applicable where the Division seeks to require combination between a nontaxpayer and a taxpayer corporation on the basis of substantial intercorporate transactions between them and relied on the following language from Matter of Campbell Sales Co. v. State Tax Commn. (68 NY2d 617, 505 NYS2d 54) for its position:

> "as we made clear [in Wurlitzer] 'it is not a condition precedent that the income or capital of the taxpayer be improperly or inaccurately reflected' before the Commission may exercise [its] discretion [under Tax Law § 211(4)] and require combined reports because of intercompany transactions" (id., 505 NYS2d at 55).

Matter of Wurlitzer v. State Tax Commn. (42 AD2d 247, 346 NYS2d 471, affd 35 NY2d 100, 358 NYS2d 762) involved a parent corporation which conducted a manufacturing operation in New York and its out-of-state subsidiary which provided financing by purchasing the parent's receivables. The parent performed all of the duties involved in collecting the receivables and received a fee from the subsidiary for doing so. All of the activities were carried out by employees of the parent since the subsidiary had no employees of its own. The taxpayer argued that the former State Tax Commission could not require a combined report because Tax Law § 211, subdivisions (4) and (5), require a showing of unfair transactions

between two corporations in this position as a prerequisite to a combined report. The Commission argued that it need not show that the intercompany transactions were unfair as between the two corporations but rather that such transactions result in an inaccurate reflection of the entire net income of the taxpayer. The Appellate Division affirmed the Tax Commission finding:

> "that the purpose of subdivisions 4 and 5 of section 211 is to prevent the distortion of the net income of a taxpayer. Such distortion, so as to inaccurately reflect the taxpayer's entire net income, can occur either through intercompany transactions or an unfair agreement. There is nothing in the statute or its legislative history which mandates a showing that intercompany transactions were unfair as a prerequisite to requiring a combined report. The instant case is proof of this proposition" (Matter of Wurlitzer Co. v. State Tax Commn., supra, 346 NYS2d at 475; emphasis added).

The Court of Appeals affirmed as follows:

> "[t]he 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.
>
> * * *
>
> "On this record, the Commission could properly conclude that separate reports would not accurately reflect the taxable income or the taxable liability. Neither in the statute nor the regulations promulgated under it, is there any requirement of 'unfairness' in transactions between the affiliated corporations.... Requiring a combined report is an accurate reflection of the income which is subject to taxation" (Matter of Wurlitzer Co. v. State Tax Commn., supra, 358 NYS2d at 766; emphasis added).

K. In a recent decision in this area, the Tax Appeals Tribunal views Campbell, Wurlitzer and the Division's regulations as supporting the conclusion that:

> "the existence of intercorporate transactions is sufficient to allow the Division to require filing on a combined basis; that the Division does not, as a 'condition precedent' to such requirement, have to show that such transactions were unfair; but that the taxpayer does have the opportunity to show that filing on a combined basis is not necessary to properly reflect tax liability." (Standard II, supra.)

The Tribunal in Standard II did not find support for the conclusion that the existence of a unitary business and substantial intercorporate transactions creates an irrebutable presumption that a combined report is necessary in order properly to reflect tax liability. Thus, the Tribunal

concluded that the issue of whether the Division properly required combination is not resolved simply by the finding that there were substantial intercorporate transactions. The inquiry must be extended to determine whether sufficient evidence was introduced to show that income would be properly reflected if reported on a separate basis. Having set forth the pertinent statute, regulations and case law, the query at this point must turn to whether petitioner has introduced such evidence to show that its income would be properly reflected if reported on a separate basis from SRAC.

L. The parties do not dispute that the two corporations are involved in substantial intercorporate transactions, and for purposes of this discussion it is assumed they are also engaged in a unitary business relationship. The parties agree that a presumption of distortion arises from the facts of the intercorporate relationship that allows the Division in the first instance to require combination, but is rebuttable nonetheless by the introduction of evidence showing that the subject income and tax liability are properly reflected by separate reporting. The disputed issue is whether sufficient evidence has been introduced by petitioner to rebut such presumption.

Proper reflection of petitioner's income and tax liability must look to the source transactions, i.e., the loans themselves. Petitioner presented the credible testimony of Robert Gurnee, a key management figure in the SRAC operation from 1958 through 1980. Intimately involved with the early years of SRAC, Mr. Gurnee testified to its historic evolution and the role played by companies such as this one. He spoke about the return rate on the loans to Sears from SRAC and characterized both the companies' manner of operations and structure of the loans as arm's-length.

Professor Sondhi capsulized his extensive experience and current review of approximately 20 independent and captive finance companies and the contractual arrangements that those companies maintained with their lenders. He compared such information to SRAC's policies. He confirmed other testimony that set forth the business reasons a finance company is utilized, especially where the borrowing power of a merchandising corporation remains so

limited. He concluded that had SRAC lent the same funds to an unrelated corporation pursuant to its lending agreement, a standard document for such transactions, the corporation would have had to meet a credit rating similar to Sears and the rate charged would have had to adhere to the ratio requirements. If Sears had borrowed from an unrelated source, it would have been facing the same charges. Testimony regarding the prime rate during the years in question established such fact. Professor Sondhi unequivocally stated that combination in this case is distortive because, from an economic viewpoint, combination ignores the fact that the income produced by SRAC would not exist if SRAC had not been created and the parent assumed such business function. Sears itself would not be able to produce the income to the extent SRAC did due to the differences in the borrowing power of the two entities and treating such income as if it had been earned by Sears overstates and distorts its income and corresponding tax liability.

The third witness presented by petitioner, Richard Genetelli of Coopers and Lybrand, additionally confirmed that separate filing would properly reflect the tax liability because the only transactions between the two corporations are clearly arm's-length. He concluded there would be an inherent distortion in combining mercantile and financial companies due to the different sources of income generation.

M. Two former State Tax Commission cases, Matter of Digital Equipment Corp. (State Tax Commission, October 14, 1985) and Matter of Boehringer Ingelheim Pharm. (State Tax Commission, April 30, 1986), dealt with the issue of the arm's-length nature of certain transactions. In Digital, the Internal Revenue Service had conducted an extensive examination of the corporation's tax returns and required adjustments under section 482 of the Internal Revenue Code for the taxable years that were in issue in the New York State tax case. The Commission held that the section 482 adjustments of the Internal Revenue Service, after an extended audit, insured that arm's-length standards were met and held that "combined reports were not necessary in order to properly reflect Digital's franchise tax liability." Although Digital involved a unique situation with facts not likely to frequently repeat, the significance of the case is the determination that combination will not be required where the taxpayer can

accurately compute its New York tax liability with the use of a measuring rod that the Division views to be as reliable as an extensive IRS audit involving section 482 adjustments.

In Boehringer, a combination was not required where the transactions between a New York parent corporation and its non-New York subsidiary were conducted pursuant to an agreement that had been negotiated in its original state by independent parties and later assumed by the parent and the subsidiary. The Commission was convinced that the arm's-length nature of the arrangement between the corporations was sufficient to conclude that combination was not necessary to accurately reflect each corporation's income.

The same issue in Standard II (supra) had a slightly different twist. In Standard II, the section 482 adjustment introduced into evidence to establish arm's-length pricing was as the result of an IRS audit change made to tax years prior to those in issue in that case. The taxpayer offered testimony to support its position that the formula being used retained its economic validity for the years in issue and resulted in an arm's-length transaction. The Tribunal in Standard II affirmed the finding of the Administrative Law Judge that the taxpayer offered "sufficient proof to show that its intercorporate transactions with [its subsidiary] were at arm's-length and that reporting on a separate basis resulted in a proper reflection of petitioner's tax liability."

N. The Division failed to rebut petitioner's position by presenting any evidence or testimony that could result in a conclusion that the transactions were not arm's-length or that separate filing would not properly reflect the tax liability of Sears.

Petitioner has achieved a critical goal necessary to overcome the presumption of distortion by its creation of a record of reports and testimony which, taken in its entirety under these facts and circumstances, meets the burden placed upon it to show that a separate filing would properly reflect petitioner's tax liability and that combination of Sears and SRAC is not necessary to achieve proper reflection.

O. Petitioner's final argument regarding factor representation is premised upon a required combination by the Division. Since it has been determined herein that petitioner may file on a

separate basis, petitioner's arguments in this regard will not be addressed.

P. The petition of Sears, Roebuck and Co. is granted and the refund claims for the fiscal year ending January 31, 1981 and calendar year ending December 31, 1981 are hereby granted in their entirety, and the notices of deficiency issued on October 22, 1984 are cancelled.

DATED: Troy, New York
January 28, 1993

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE