STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PENTHOUSE INTERNATIONAL, LTD.	:	DETERMINATION DTA NO. 806745
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1978 through 1981.	:	

Petitioner Penthouse International, Ltd., 1965 Broadway, New York, New York 10023 filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1978 through 1981.

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on July 31, 1991 at 2:15 P.M. Petitioner filed a brief on November 14, 1991. The Division of Taxation filed a brief on February 24, 1992. Petitioner filed a reply brief on March 25, 1992. Petitioner appeared by Lefrak, Newman & Myerson (Thomas A. Holman, Esq., Joseph S. Lefrak, Esq., and Donald J. Reiser, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether petitioner may properly file a combined franchise tax report with certain affiliated corporations for the year 1978 and thereby properly deduct from its entire net income certain losses attributable to said affiliates.

II. Whether petitioner properly computed the receipts factor component of its business allocation percentage with respect to the year 1978.

III. Whether petitioner has established entitlement to a claimed investment tax credit for the year 1981.

FINDINGS OF FACT

Petitioner, Penthouse International, Ltd., was incorporated under the laws of the State of New York on September 28, 1967.

For its taxable year 1978, petitioner filed Form CT-3, State of New York Corporation Franchise Tax Report, reporting Federal taxable income of $2,725,893.00. On its pro forma Federal income tax return for the same year, petitioner reported Federal taxable income of $14,487,487.00.

Petitioner filed a consolidated Federal income tax return with certain affiliated corporations for the taxable year 1978. No copy of this return was entered into the record and the identity of such subsidiaries and affiliates is not contained in the record.

Petitioner filed a separate New York State Corporation Franchise Tax Report for the taxable year 1978. Petitioner calculated its tax liability for 1978 on the basis of its entire net income.

In calculating Federal taxable income for purposes of filing its 1978 New York State Corporation Franchise Tax Report, petitioner deducted from its pro forma Federal taxable income of $14,487,487.00 an amount totalling $11,761,594.00 which was characterized by petitioner as losses of various affiliates in amounts as follows:

Affiliate	Claimed Losses
Viva International, Ltd.	$ 2,755,611
Penthouse Films International, Ltd.	4,751,731
Omni Publications International, Ltd.	4,167,276
C-P Records	68,563
Bravo International, Ltd.	4,719

Penthouse Communications, Ltd.	6,658
Penthouse/Viva Leisure Club, Ltd.	3,288
Unlocated Difference[1]	3,748
	$11,761,594

The Division of Taxation ("Division") conducted an audit of petitioner for the years 1978 through 1981. For 1978, the Division made certain adjustments in petitioner's franchise tax report. Primary among these adjustments was the Division's disallowance of petitioner's deduction of claimed losses of the affiliate corporations from petitioner's individually filed pro forma Federal taxable income (see Finding of Fact "5"). The Division thus added back $11,761,594.00 to petitioner's reported entire net income for 1978. This adjustment was disputed by petitioner.

Another adjustment to the 1978 report disputed by petitioner was the Division's adjustment to petitioner's reported receipts factor. On Schedule G (Business Allocation) of its 1978 report, petitioner reported sales of tangible personal property in New York of $4,732,783.00 and sales of tangible personal property everywhere of $75,785,162.00 for a reported receipts factor of 6%. (The actual result of the computation is 6.24%.) Petitioner reported no other receipts on the Schedule G. On audit, the Division increased petitioner's sales of tangible personal property everywhere by $30,181,295.00 to $105,966,457.00. These figures appear to have been taken from petitioner's individual pro forma 1978 United States corporate income tax return, line 1 ("Gross receipts or gross sales $105,966,457 . . . Less: Returns and allowances $30,181,295"). The Division also increased petitioner's sales in New York by $12,403,864.00.

The only explanation for this adjustment in the record is the following statement contained in the audit report:

> "For 1978 and 1981 sales were understated both in New York and Everywhere. This was due to taxpayer's reporting of advertising sales on the lower basis of circulation sales."

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[1]There is no explanation in the record for this amount.

The foregoing adjustments resulted in an audited receipts factor of 16.17%. Coupled with small adjustments to petitioner's reported property factor (not contested herein) and petitioner's reported wage factor the total adjustment resulted in an audited business allocation percentage of 42.05%. Petitioner reported a business allocation percentage of 36.75%.

Also noteworthy with respect to 1978, petitioner reported no subsidiary capital on Schedule C of the report and therefore computed no tax on subsidiary capital. On audit, the Division computed petitioner's 1978 tax on subsidiary capital as follows:

	Avg. FMV	Issuer's Alloc. %	Value Alloc. to NYS
Omni	$1,574,002	0%	$ 0
Forum	3,000	100%	3,000
Viva	6,498,900	100%	6,498,900
Follycons, Inc.	19,035	100%	19,035
Penthouse[2]	11,641	100%	11,641
Penthouse	22,230	100%	22,230
Penthouse	82,498	100%	82,498
Value allocated to NYS	$8,211,306	80.83%	$6,637,304
Tax @ .0009			5,974

As a result of the foregoing adjustments, the Division determined a corporation franchise tax deficiency for petitioner with respect to 1978 of $522,059.00.

For the year 1981, petitioner filed a consolidated New York State Franchise Tax Report with its wholly-owned subsidiary, Penthouse Export Corp., a domestic international sales corporation ("DISC"). Petitioner calculated its tax liability for 1981 on the basis of its capital. As part of said report, petitioner claimed an investment tax credit of $14,706.00, additional investment tax credit of $43,839.00 and unused investment tax credit from a preceding period of $803.00, for a total investment tax credit of $59,348.00. Petitioner's calculation of its tax liability for 1981 resulted in tax due of $46,424.00. Petitioner

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[2] The audit report lists what are apparently three separate entities as "Penthouse". The audit report provides no further information regarding the identity of these entities.

used $46,174.00 of its claimed credit to offset its 1981 liability (except for $250.00 minimum tax).

On audit, the Division made certain adjustments to petitioner's 1981 report. Pursuant to such adjustments, the Division calculated total tax due of $3,617.00 and applied $3,367.00 in tax credits against such liability, leaving minimum tax due of $250.00. Also on audit, the Division disallowed petitioner's claimed investment tax credit of $14,760.00 for 1981. Accordingly, after allowing for such disallowance and the application of credit per the Division's computations, the Division determined a tax credit available for carryforward of $40,472.00.

With respect to the credit disallowed by the Division, on its claim for investment tax credit for 1981, petitioner described the property upon which credit was claimed as "equipment" with a manufacturing and productive use of "production of magazine" acquired in 1981 at a cost of $367,662.00.

The investment tax credit disallowance was the only adjustment challenged by petitioner with respect to the 1981 report.

As a result of the adjustments made by the Division with respect to petitioner's 1978 New York Corporation Franchise Tax Report (see Findings of Fact "6" through "10"), on October 23, 1985 the Division issued to petitioner a Notice of Deficiency which asserted additional tax due under Article 9-A of $522,059.00, plus interest, for the year 1978.

Petitioner did not request permission to file its franchise tax reports for 1978 or the 1978-1981 period on a combined basis during the course of the field audit. Additionally, on audit the Division did not analyze whether such combination should be permitted. Further, petitioner did not formally make a request for combination within 30 days of the close of any of the taxable periods at issue. Petitioner also did not request combination in its petition in the instant matter.

At the hearing in this matter, petitioner requested

permission to file franchise tax reports on a combined basis with the corporations listed in Finding of Fact "5" for the year 1978.

During 1978, petitioner, Viva International, Ltd. ("Viva") and Omni Publications International, Ltd. ("Omni") were each engaged in the business of publishing magazines.

The business of Penthouse Films International, Ltd. ("Films"), Penthouse Communications, Ltd. ("Communications"), Bravo International, Ltd. ("Bravo"), Penthouse/Viva Leisure Club, Ltd. ("Leisure") and C-P Records was described in the record as publishing and entertainment. There is no evidence in the record regarding what these entities published.

There is evidence in the record that Films was involved in film production and, pursuant to an agreement dated December 3, 1975, had produced a film for petitioner entitled "Caligula". There is no evidence in the record of Films' business activities during 1978.

Leisure was described in the record by petitioner's controller as having "attempted to form a leisure club" that "never got off the ground."

Other than the general description of entertainment, there is no evidence in the record as to the activities of Communications, Bravo or C-P Records during 1978.

Omni, Communications and Leisure were New York corporations. Viva, Films and Bravo were Delaware corporations.

Regarding C-P Records, the record is unclear as to whether this entity is in fact a corporation. In contrast to the numerous references made to the other affiliates, the sole reference to this entity contained in the documentation submitted into the record herein is contained in the schedule attached to petitioner's 1978 franchise tax report listing the losses set forth in Finding of Fact "5".

There is conflicting evidence in the record regarding the

ownership of Viva, Omni and Films. Petitioner took the position that all three entities were its wholly-owned subsidiaries and the record contains evidence to support this contention.

It appears that, on audit, the Division considered at least Omni and Viva to be petitioner's subsidiaries. This is evidenced by the Division's assertion of tax on petitioner's subsidiary capital (see Finding of Fact "9"). Also, the Division did not contest this issue in its answer (which made reference to "subsidiaries") or at hearing. Additionally, while the identity of the consolidated group with which petitioner filed its Federal returns was not entered into the record, a Closing Agreement between petitioner and the Internal Revenue Service dated February 7, 1987 refers to Films as petitioner's subsidiary.

The record also contains evidence indicating that Omni, Viva and Films were not wholly-owned subsidiaries of petitioner. Specifically, petitioner entered into the record audited financial statements of "Penthouse International, Ltd. and Wholly-Owned Subsidiaries" for the years 1977 and 1978. (The statements do not name the referred-to wholly-owned subsidiaries.) These statements were prepared by Fiddler and Rukin, P.C., C.P.A.'s. Among the notes to these statements was the following:

> "Penthouse International, Ltd. has a financial interest in FORUM International, Inc., VIVA international [sic], Ltd., EVELYN RAINBIRD, Ltd., P-H Construction Corporation, OMNI Publications International, Ltd. and PENTHOUSE Films International, Ltd., by virtue of an investment in the non-participating preferred stock of each company. Penthouse International, Ltd. does not participate in the equity of these companies, and, accordingly, they are not consolidated for financial reporting purposes." (Emphasis supplied.)

Petitioner also entered into the record "Consolidated Financial Statements Viva International, Ltd. and Wholly-Owned Subsidiary December 31, 1978 and 1977." This statement also indicated that petitioner had an interest in Viva by virtue of an investment in Viva's non-participating preferred stock, but that petitioner did not participate in the equity of Viva.

Also, on petitioner's 1978 franchise tax report, schedule C (subsidiary capital and allocation), petitioner listed no corporations in which it owned more than 50% of the voting stock. In contrast, on petitioner's 1981 report, petitioner listed 80% ownership of the voting

stock in Omni, Viva and Forum International.

The consolidated financial statement of Viva entered into the record indicates that, as of December 31, 1978, Viva had 200 shares of common stock and 400 shares of preferred stock authorized, issued and outstanding. According to documents submitted into the record, as of February 13, 1973, Viva had accepted petitioner's offer to purchase 400 shares of preferred stock and the offer of the R. C. Guccione Family Trust No. 1 to purchase 200 shares of common stock.

The record indicates that as of July 20, 1978 petitioner owned 20 shares of preferred stock of Omni and the R. C. Guccione Family Trust No. 1 owned 10 shares of common stock of Omni. There is no evidence in the record as to the total number of shares of Omni common and preferred stock authorized, issued and outstanding. There is no evidence in the record identifying the trustees or beneficiaries of the R. C. Guccione Family Trust No. 1.

Bravo, Communications and Leisure were each wholly-owned subsidiaries of petitioner.

The record does not indicate whether any members of the proposed combined group filed franchise tax reports for 1978. The record also does not contain separate basis reports for 1978 for any members of the proposed group.

The consolidated financial statement of petitioner indicates $29,301,399.00 due from affiliated companies to petitioner for 1978. The consolidated financial statement of Viva indicates $13,126,743.00 due to affiliated companies for 1978.

Pursuant to an Agreement of Lease, dated November 30, 1976, petitioner entered into a three-year lease for the entire 20th floor and a portion of the 21st floor at 909 Third Avenue, New York, New York. During 1978, petitioner and the entities which comprise the proposed combined group conducted business at this location. Petitioner paid the rent for the entire premises.

Petitioner provided certain administrative and management services to the members of the proposed combined group. Specifically, petitioner's purchasing department handled all purchases of paper, supplies and other materials for petitioner, Omni and Viva. All bills for

purchases were handled by petitioner's accounts payable department. Petitioner maintained a single checking account in its name at Manufacturer's Hanover Trust and issued checks from that account to pay any bills on behalf of itself and the members of the proposed combined group. Additionally, petitioner's accounting department maintained records for petitioner and the group. Petitioner's payroll department paid all employees who worked for petitioner and the group. Also, petitioner, Viva and Omni used the same production department, subscription department and public relations department.

Each of the magazines (i.e., Penthouse, Omni and Viva) maintained separate editorial departments.

As noted, petitioner made purchases and paid bills on behalf of the proposed combined group. Petitioner then charged the appropriate entity for such payments through accounting entries on petitioner's books and records. Where a bill was incurred directly by a particular corporation, that corporation was charged the full amount of such bill. If the bill constituted an indirect or general charge, petitioner attempted to charge the various entities a proportionate share.

None of the members of the proposed group maintained a checking account.

To the extent that outside financing was required in connection with the operations of the members of the proposed combined group, such financing was obtained by petitioner. In such cases, the group members guaranteed the loans made to petitioner or provided collateral for such loans.

Petitioner provided financing for the operations of certain of the members of the proposed group through intercompany loans.

On September 19, 1977, petitioner and Viva (along with other entities not among the group listed in Finding of Fact "5") entered into a distribution agreement with Curtis Circulation Company whereby Curtis agreed to distribute the magazines published by petitioner, Viva and the other entities. In 1978, the distribution agreement was modified to include Omni.

The magazines published by Viva and Omni each advertised in the magazine published

by petitioner. In such cases, petitioner charged Omni or Viva for the paper and printing costs of running the particular advertisement in petitioner's magazine.

Mr. Robert C. Guccione, Mr. Anthony J. Guccione and Mr. Irwin E. Billman comprised the board of directors of the following corporations: Penthouse International, Ltd.; Viva International, Ltd.; Omni Publications, Ltd.; Penthouse Communications, Ltd.; Bravo International, Ltd.; and Penthouse/Viva Leisure Club, Ltd.

Mr. Robert C. Guccione was president and chairman of petitioner and was president of each of the members of the proposed combined group. The 1978 pro forma Federal income tax return of petitioner indicated that Mr. Guccione owned 66-2/3% of petitioner's stock. Mr. Irwin E. Billman was executive vice president of petitioner and Viva.

Additionally, Mr. Marc Bendesky, who was petitioner's controller during 1978, also served as controller for the members of the proposed group. Mr. Bendesky and his staff were responsible for maintaining the books and records for petitioner and the affiliated corporations.

Petitioner was not compensated for the general and administrative services it provided to the members of the proposed combined group.

The nature and extent of the general and administrative services petitioner provided to Films, Bravo, Communications, Leisure and C-P Records is unclear given the dearth of information in the record regarding the activities of these entities during the year at issue (see Findings of Fact "19" through "22").

At a point prior to January 1979, petitioner acquired a leasehold interest in property located at 67th Street, New York, New York. Petitioner undertook a complete renovation of the property for the purpose of converting it for use as an office for Mr. Robert Guccione, as a production facility in connection with the publication of magazines, and for non-business use. The improvements were made by Cauldwell-Wingate Co., Inc., an independent contracting firm. The property contained approximately 15,000 square feet of space. Of this amount, petitioner estimated that 8,000 square feet were used for business purposes. Of this 8,000 square feet, petitioner estimated that 5,000 square feet were used in connection with the

production of magazines, including a film laboratory, photo library and a 600-square foot room containing slide equipment. Petitioner's records (Exhibit "19") indicate expenditures totaling $4,699,963.17 classified as leasehold improvements to the "67th Street mansion" for 1979. Petitioner claimed an investment tax credit for 1979 based upon expenditures totaling $4,881,684.00. The difference between these two figures appears from the record herein (specifically Exhibit "22") to result from expenditures classified as furniture and fixtures.[3] For 1980, petitioner's records (Exhibit "20") indicate leasehold improvements to the 67th Street mansion of $1,246,860.62. The summary of petitioner's tax credit

computations for 1980 entered into the record (Exhibit "22") indicates leasehold improvements with respect to the 67th Street mansion of $1,449,031.00, furniture and fixtures expenditures for the mansion of $362,248.00, and $31,790.00 for what appears to be an additional furniture and fixtures expenditure. For 1981, petitioner's records (Exhibit "21") indicate leasehold improvements to the 67th Street mansion of $195,986.28. With respect to 1981, Exhibit "22" indicates leasehold improvements for the mansion of $195,986.00, furniture and fixtures for the mansion of $140,695.00 and an additional furniture and fixtures expenditure of $30,981.00, for a total expenditure of $367,662.00 from which petitioner's claim of $14,706.00 in credit for 1981 was calculated. In contrast to its investment tax credit calculations for 1979 and 1980, it does not appear that petitioner made an allocation with respect to the relative square footage of the mansion used in production in its calculation of its 1981 investment tax credit claim.

Petitioner introduced into the record certain documents (Exhibit "17") listing certain of the alterations to the 67th Street property. Among the items so listed were the following: structural alterations; windows; skylights; bath accessories/sauna; greenhouse; elevator/dumbwaiter; tile and stone; HVAC; and electric.

No evidence was presented to tie the $367,662.00 of expenditures which formed the

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[3]Exhibit "22", a workpaper summarizing petitioner's investment tax credit computations for the years 1979, 1980 and 1981, lists this expenditure as "F + F Mansion".

basis of the 1981 investment tax credit claim to specific purchases of specific items. In other words, the items which comprise the $367,662.00 of purchases were not identified in the record.

On January 10, 1990, General Media International, Inc., a successor corporation to petitioner, filed a formal request for permission to file a combined franchise tax report with several affiliated corporations commencing with the year 1989. Three of the corporations for which petitioner requests combination in the instant proceeding were included in this January 10, 1990 request: Penthouse International, Ltd.; Viva International, Ltd.; and Omni Publications, Ltd.

By letter dated January 22, 1990, the Division granted tentative permission to General Media International, Inc. to file a combined report with a number of subsidiary corporations, including Penthouse International, Ltd.; Omni Publications, Ltd.; and Viva International, Ltd. Such tentative permission to file a combined report was subject to subsequent audit by the Division.

General Media International did not include within the proposed combined group Penthouse Films International, Ltd., which appears from the record (Exhibit "14") to have been an active corporation at the time of General Media's application. Penthouse Communications, Ltd. was also not included within General Media's proposed combined group. General Media's application lists this entity as "inactive". General Media's application makes no reference to C-P Records, Bravo International, Ltd. or Penthouse/Viva Leisure Club, Ltd.

In its petition, petitioner alleged that the Commissioner of Taxation and Finance erred by not accepting a Report of Change in Taxable Income by the U.S. Treasury Department, filed May 13, 1987, and the resulting claims for refunds of overpaid tax arising therefrom. Inasmuch as petitioner did not further raise this issue either at hearing or on brief, it is concluded that petitioner has abandoned this allegation of error.

Petitioner submitted proposed findings of fact numbered "1" through "37". Throughout the proposed findings petitioner referred to the members of the proposed combined group as "the subsidiaries". This characterization is rejected as the facts as found herein distinguish

among the members of the proposed combined group and do not find that all such members were, in fact, subsidiaries of petitioner. With that proviso, the following proposed findings are generally accepted and have been, in substance, incorporated into the Findings of Fact herein: "1" through "4", "6", "7", "11", "12", "14" through "19", "21" through "33", "36" and "37". Proposed finding "8" is, in substance, accepted except for the third sentence thereof. Proposed finding "9" is, in substance, accepted except for the first sentence thereof. Proposed finding "10" is, in substance, accepted except for the second sentence thereof. Proposed findings "5", "13", "20", "34" and "35" are rejected. These proposed findings are rejected (in whole or in part) because they are unsupported by the record.

CONCLUSIONS OF LAW

A. Tax Law § 211(4) provides, in part, as follows:

> "In the discretion of the tax commission,[4] any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such information as the tax commission may require; . . . 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 inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article."

B. The regulations in effect during the years in issue, 1976 through 1981, were those promulgated by the former New York State Tax Commission on August 31, 1976 which apply to taxable years beginning on or after January 1, 1976.

C. The regulation at 20 NYCRR former 6-2.1(a) provided, in part, as follows:

> "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

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[4] 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 administrative hearing process, are deemed to refer to the Division of Taxation or Commissioner of Taxation and Finance.

Commission, in its discretion, may require a group of corporations to file a combined report or may grant permission to a group of corporations to file a combined report where the requirements of stock ownership or control are met."

D. The regulation at 20 NYCRR former 6-2.4 provided as follows:

"(a) A taxpayer must make a written request for permission to file a combined report. The request must be received by the Tax Commission not later than thirty (30) days after the close of its taxable year. A report filed on a combined basis does not constitute a request for permission to file a combined report. A request to file a combined report must include the following information:

"(1) the exact name, address, employer identification number and the state of incorporation of each corporation to be included in the combined report.

"(2) information showing that each of the corporations meets the requirements of section 6-2.2 of this Subpart for the current year [unity of ownership requirement, see Conclusion of Law "G"],

"(3) the exact name, address, employer identification number and the state of incorporation of all corporations (except alien corporations) which meet the requirements of section 6-2.2 of this Subpart for the current year which are not to be included in the combined report,

"(4) for at least the first nine (9) months of the current year submit the following information --

"(i) the nature of the business conducted by each corporation included in paragraphs (1) and (3) of this subdivision,

"(ii) the source and amount of gross receipts of each corporation and the portion derived from transactions with each of the other corporations,

"(iii) the source and amount of intercorporate purchases, services and other intercorporate transactions, and

"(iv) any other data that shows the degree of involvement of the corporations with each other, and

"(5) a statement providing details as to why a combined report which would include only the corporations listed in paragraph (1) of this subdivision will equitably reflect the New York State activities of the corporations which meet the requirements of section 6-2.2 of this Subpart and why the corporations in paragraph (3) of this subdivision should be excluded.

"(b) A written request for permission to include or exclude a corporation from an existing combined report must be received by the Tax Commission not later than thirty (30) days after the close of the taxable year of the corporations filing the combined report. The information required by paragraphs (2), (4) and (5) of subdivision (a) of this section must be submitted with the request.

"(c) The Tax Commission's approval to file a combined report or to include or exclude a corporation from a combined report is tentative pending receipt of the final report and subject to revision or revocation on audit. If a combined report is

> submitted without the Tax Commission's permission, or if a corporation is included in a combined report without permission, the Tax Commission will compute and assess the tax of each taxpayer filing without permission on a separate basis.
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> "(d) If a corporation has been required or has been permitted to report on a combined basis, the corporation must continue to file its reports on a combined basis. If the facts change, a corporation may submit a request to the Tax Commission for approval to no longer file on a combined basis or the Tax Commission may require that a combined report not be filed."

E. The foregoing regulations provide a standard pursuant to which the discretion of the Division is to be exercised (Montauk Improvement v. Proccacino, 41 NY2d 913, 394 NYS2d 619). In the instant matter, however, the request for combination was made at the hearing. It therefore cannot be said that the Division abused its discretion on audit in requiring petitioner to file a separate report since petitioner had not, at that time, requested permission to file a combined report. The question is thus whether petitioner's request for permission to file on a combined basis should be rejected as untimely. There appear to be two Tax Appeals Tribunal cases relevant to this inquiry.

In Matter of Autotote, Ltd. (Tax Appeals Tribunal, April 12, 1990), the Tribunal determined that the Division had abused its discretion under Tax Law § 211(4) by refusing to allow the petitioner in that case to file on a combined basis where the petitioner requested combined filing during the course of the audit and where the facts determined on audit and stipulated to by the parties indicated that the petitioner met the conditions of the Division's regulations on combined reporting. In Autotote, the sole reason advanced by the Division for its refusal to grant permission to file combined reports was the petitioner's failure to timely request permission to file combined reports pursuant to 20 NYCRR former 6-2.4(a). The Tribunal rejected the Division's position as follows:

> "[T]he only ground advanced by the Division for not allowing petitioner to file on a combined basis is the failure to comply with the thirty-day rule. We find this position wholly untenable in this case. The purpose of the thirty-day rule would appear to be to permit the Division to establish the tentative filing status of a taxpayer prior to the time the returns are due. Although the Division reserves the right to require combination or decombine a taxpayer on audit (20 NYCRR 6-2.4[c]), the application and approval process allows the taxpayer to know how it should file and allows the Division to know from whom to expect a return. Even if there are other reasons for the thirty-day rule and the permission process, such reasons cannot be used to prohibit a taxpayer from filing on a combined basis

> where, as in the instant case, the Division, on its own initiative, has had the opportunity through the audit process to examine and scrutinize petitioner's business activities, in particular intercompany transactions." (Matter of Autotote, Ltd., supra.)

Petitioner contends that the instant matter falls within the rule articulated in Autotote. Petitioner argues that, as in Autotote, the Division conducted an in-depth field examination of petitioner's business and its dealings with its subsidiaries. Petitioner further contends that:

> "[t]he issue of combination was therefore clearly presented to the Division both by the manner in which [p]etitioner filed its returns for these years and by the extensive documentation that was provided to the Division during the course of the audit." (Petitioner's Reply Brief, p. 12.)

Accordingly, petitioner argues, the instant matter is indistinguishable from Autotote.

The Division contends that the instant matter is factually distinguishable from Autotote. The Division contends that, in the instant matter, unlike Autotote, there was no in-depth field audit analysis of petitioner's relationship with the subject affiliates. Accordingly, the Division contends that petitioner's request to file combined reports was untimely within the meaning and intent of the Division's regulations.

In support of its position, the Division cited Matter of Chudy Paper Co. (Tax Appeals Tribunal, April 19, 1990). In that case, the Tribunal denied a retroactive request for combination and applied the so-called 30-day rule where a taxpayer, having failed to make a timely request for combination, filed combined reports nonetheless. The Tribunal distinguished Autotote on the ground that no field audit of the petitioner was conducted in Chudy Paper.

In support of its decision in Chudy Paper, the Tribunal cited Fuel Boss v. State Tax Commn. (128 AD2d 945, 512 NYS2d 595), wherein the Court confirmed a determination of the former State Tax Commission which denied a taxpayer retroactive permission to file combined reports where the taxpayer had filed combined reports for those years without obtaining prior permission.

F. In this case, unlike Chudy Paper or Fuel Boss, the Division did conduct an in-depth field audit. Unlike the petitioner in Autotote, however, petitioner herein did not request

combination during the course of the audit.[5] Further, this is clearly not a case wherein the Division determined "after an audit that a taxpayer's tax liability in New York State will be properly reflected only if the taxpayer files a combined report" (Matter of Autotote, Ltd., supra), for, unlike Autotote, the Division herein has disputed the propriety of combination on substantive grounds. While the Division, "on its own initiative, has had the opportunity through the audit process to examine and scrutinize petitioner's business activities, in particular intercompany transactions" (Matter of Autotote, Ltd., supra), since the combination issue was not raised on audit, the Division's "opportunity" to examine this issue was not meaningful.

Tax Law § 211(4) invests the Division with discretion to require or permit combined reporting under certain circumstances. The Division, however, must have a meaningful opportunity to exercise this discretion. Where, as here, the issue of combination is not raised until the hearing, the Division has not had such an opportunity and the request must be considered untimely within the meaning of Fuel Boss and Chudy Paper. The Division's refusal herein to permit combination is therefore not an

abuse of discretion under Tax Law § 211(4) and petitioner's request for combination is therefore properly denied herein.

G. Even assuming that the merits of the combination issue are properly at issue herein, the record herein nonetheless compels the conclusion that petitioner has failed to establish that it should be permitted to report on a combined basis with the members of the proposed combined group.

The regulations set forth as a threshold requirement a unity of ownership among the members of the proposed group. 20 NYCRR former 6-2.2 expounded upon this initial requirement as follows:

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[5]Petitioner's contention that the combination issue was before the auditor is rejected. The fact that petitioner improperly computed its entire net income does not constitute raising the combination issue. As to the purported voluminous documentation reviewed on audit, the record in this matter does not reveal what documentation was reviewed by the Division on audit.

"(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.

"(b) The term 'substantially all' means ownership or control of eighty percent (80%) or more of the voting stock. Ownership includes actual or beneficial ownership. To be considered the owner, the stockholder must have the right to vote and the right to receive dividends. The term 'control' refers to all cases where the taxpayer controls the stock of all the other corporations or the stock of the taxpayer is controlled by other corporations or the taxpayer and the other corporations are controlled by the same interests. The decision as to whether or not a corporation is controlled by or controls another corporation or is controlled by the same interests will be determined by the facts in each case."

Once a determination of unity of ownership was made, the regulation at 20 NYCRR former 6-2.3(a) required an exercise of discretion by the Tax Commission with regard to the permission or requirement for combined reporting based upon whether the corporations were in substance parts of a unitary business conducted by the entire group of corporations and whether there were substantial intercorporate transactions among the corporations. With regard to the requirement that the corporations be parts of a unitary business, the regulation states that 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 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." (20 NYCRR former 6-2.3[b].)

The regulation also sets forth guidelines for determining substantial intercorporate transactions as follows:

> "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." (20 NYCRR former 6-2.3[c].)

Ultimately, whether a taxpayer is permitted or required to file on a combined basis with other corporations is determined after considering whether, under all of the circumstances of the intercompany relationships, combined reporting fulfills the statutory purpose of avoiding distortion of, and more realistically portraying, true income (Matter of Coleco Indus. v. State Tax Commn., 92 AD2d 1008, 461 NYS2d 462, affd 59 NY2d 994, 466 NYS2d 682).

H. Based on the record herein, petitioner has failed to establish that it and the members of the proposed combined group meet the requirements of filing on a combined basis as outlined by the former regulations or that combined reporting would fulfill the statutory purpose of avoiding distortion of, and more realistically portraying, true income.

Petitioner has failed to establish that it owned substantially all the capital stock of Viva, Omni, Films and C-P Records. While it appears that, on audit, the Division considered Omni, Viva and Films to be subsidiaries of petitioner (see Finding of Fact "26") and at hearing, the Division did not specifically dispute petitioner's ownership of the members of the proposed group, the financial statements submitted into the record by petitioner state that petitioner did not "participate in the equity" of Omni, Viva or Films and further indicate that petitioner's interest was limited to an interest in the "non-participating" preferred stock of these

corporations (see Findings of Fact "27" and "28"). In light of this evidence, it must be concluded that petitioner has failed to meet the threshold test of ownership with respect to Viva, Omni and Films. With respect to C-P Records, the record also shows no evidence of ownership or control of this entity by petitioner, and also fails to establish that this entity was, in fact, a corporation (see Finding of Fact "24").

The record does establish that Bravo, Communications and Leisure were wholly-owned subsidiaries of petitioner. Petitioner has thus met the unity of ownership requirement for these corporations. The record, however, fails to establish that Bravo, Communications and Leisure met the unitary business and substantial intercorporate transactions requirements for combined reporting. Petitioner described Bravo, Communications and Leisure's activities as being in the publishing and entertainment business and that Leisure unsuccessfully attempted to form a club. Beyond that, the record fails to show the degree to which these entities were engaged in the same or similar lines of business as petitioner. The record also provides no specifics of the publishing activities of these entities. Further, while the record contains specific evidence of intercorporate transactions between petitioner and Viva and Omni, the record contains no specific evidence of transactions between petitioner and Bravo, Communications and Leisure. Since it is unclear what business these entities were engaged in, the specific nature and extent of intercorporate transactions between petitioner and these entities is uncertain.

It is also noted that franchise tax regulation 20 NYCRR former 6-2.4 lists information which should be provided by a taxpayer when requesting to file on a combined basis. As discussed above, none of this information is contained in the record herein.

I. With respect to the issue raised by petitioner regarding the computation of its receipts factor for 1978, it is clear that receipts from advertising sales may be properly allocated based upon the ratio of New York circulation to total circulation (see, McGraw-Hill, Inc. v. State Tax Commn., 146 AD2d 371, 541 NYS2d 252, affd 552 NYS2d 915, 75 NY2d 852). Petitioner contended that this was precisely the manner by which it calculated its receipts factor for its 1978 report. Petitioner's contention is supported by the Division's explanation for its

adjustment as stated in the audit report (see Finding of Fact "7"). The Division's adjustment to petitioner's receipts factor was therefore improper. The Division is therefore directed to recompute petitioner's business allocation percentage for 1978 using petitioner's receipts factor as reported on its 1978 report and to adjust petitioner's tax liability accordingly.

J. Tax Law § 210(12)(b) provides for an investment tax credit under Article 9-A with respect to:

> "tangible personal property and other tangible property, including buildings and structural components of buildings, which are: depreciable pursuant to section one hundred sixty-seven of the internal revenue code or recovery property with respect to which a deduction is allowable under section one hundred sixty-eight of the internal revenue code, have a useful life of four years or more, are acquired by purchase as defined in section one hundred seventy-nine (d) of the internal revenue code, have a situs in this state and are principally used by the taxpayer in the production of goods by manufacturing, processing . . . ."

K. Petitioner has failed to establish entitlement to the investment tax credit claimed on its 1981 corporation franchise tax report. The record herein shows that about one-third of the available space in the property in question was used for production of magazines. Specifically, petitioner's witness testified that of the 15,000 square feet of available space in the 67th Street property, 8,000 square feet were used for business purposes and, of that 8,000 square feet, 5,000 square feet were used in the production of magazines. It is therefore clear that expenditures for improvements to the 67th Street property were not necessarily directly used in the production of magazines. Furthermore, the record contains no evidence specifically identifying the $367,662.00 worth of expenditures which form the basis of petitioner's 1981 claim for credit. Under such circumstances it cannot be determined whether the expenditures in question were, in fact, principally used by petitioner in production as required by Tax Law § 210(12)(b). Accordingly, petitioner has failed to establish entitlement to its claimed investment tax credit for 1981 and the Division's disallowance thereof must be sustained.

L. The petition of Penthouse International, Ltd. is granted to the extent indicated in Conclusion of Law "I". The petition is in all other respects denied. The Division is directed to adjust the Notice of Deficiency dated October 23, 1985 in accordance therewith; and, as so adjusted, the notice is sustained.

DATED: Troy, New York
November 5, 1992

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE