

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
HEIDELBERG EASTERN, INC.	:	
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1983 through 1986.	:	
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In the Matter of the Petition	:	DETERMINATION
of	:	DTA NOS. 806890
EAST ASIATIC COMPANY, INC.	:	AND 807829
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1980 , 1981 and 1985.	:	

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Petitioner Heidelberg Eastern, Inc., 73-45 Woodhaven Boulevard, Glendale, New York 11385 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 1983 through 1986.

Petitioner East Asiatic Company, Inc., 73-45 Woodhaven Boulevard, Glendale, New York 11385 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 1980, 1981 and 1985.

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 29 and 30, 1991, with additional evidence submitted by September 30, 1991. Petitioners filed a brief on November 4, 1991. The Division of Taxation filed a brief on April 23, 1992. Petitioners filed a reply brief on May 20, 1992. Petitioners submitted proposed findings of fact and conclusions of law on November 12, 1991. Petitioners appeared by Morrison & Foerster (Hollis L. Hyans, Esq., and Arthur R. Rosen, 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 denied petitioners permission to file combined corporation franchise tax reports for their fiscal years ended December 31, 1983, December 31, 1984 and June 30, 1985.

II. If so, whether penalties imposed herein should be sustained.

### FINDINGS OF FACT

Petitioner Heidelberg Eastern, Inc. ("Heidelberg") is a Delaware corporation. During the period at issue (and subsequently), Heidelberg was doing business in New York State. Heidelberg also had operations in Illinois and Georgia during this period. Heidelberg's corporate headquarters are located in Glendale, New York. At all times relevant herein, its principal business was importing graphic arts equipment, primarily printing presses. Heidelberg also imported related equipment such as paper cutters and folding equipment. Approximately 80% of Heidelberg's business was derived from this importing activity.

Petitioner East Asiatic Company, Inc. ("EAC") was a California corporation. EAC was also doing business in New York State during the period at issue. EAC was the wholly-owned subsidiary of East Asiatic Company, Ltd., a Danish corporation. Prior to April 1984, EAC's administrative offices and certain of its divisional offices were located in Springfield, New Jersey. After that time, such offices were moved to Glendale, New York, at the same location as Heidelberg's corporate offices.<sup>1</sup>

During the period at issue, EAC's principal business, conducted through its Plumrose division, consisted of importing and processing food products, primarily meats. Through its other divisions, EAC also imported other products, including wood products (EAC Timber) and specialized machinery (EAC Engineering), and it also exported graphic arts equipment (EAC Trading). Additionally, EAC's Steamship Agents division was an agent for ocean vessels. In years prior to the period at issue, EAC had also imported coffee and rice. During the period at

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<sup>1</sup>One EAC division, EAC Trading, was moved to the Glendale, New York location in 1982.

issue, approximately 60% of EAC's income was derived from importing.

EAC had divisional offices and facilities throughout the country. About one-fourth of EAC managers were located at the Glendale offices. Plumrose, EAC's food importing and processing operation, had four plants in the United States. Two Plumrose plants were engaged in the production of ham, bacon and other luncheon meats and two were engaged in meat slicing operations.

Prior to July 1, 1985, Heidelberg was a wholly-owned subsidiary of EAC.

Heidelberg was established in 1971 to be the sole distributor in the eastern United States of printing presses manufactured by Heidelberger Druckmaschinen ("HDM"), a German corporation unaffiliated with Heidelberg or

EAC. EAC chose to organize Heidelberg as a separate corporation because HDM wanted to maintain the "Heidelberg" name.

Prior to 1971, a separate company also called Heidelberg Eastern, Inc. ("Old Heidelberg"), was the distributor of HDM presses. Old Heidelberg was profitable, but stagnant, with annual sales of \$8 to \$9 million. It handled only one product line, the HDM printing presses. Heidelberg acquired the assets of Old Heidelberg in a transaction that closed December 31, 1970.

Prior to the commencement of operations of Heidelberg, EAC's Danish parent had been involved in the distribution of HDM products to other parts of the world. At the point when Old Heidelberg's owner wanted to get out of the business, HDM asked EAC's parent to acquire Old Heidelberg's assets, and the sale to EAC was subsequently arranged.

At all times relevant herein, Heidelberg's principal products were the HDM line of printing presses. Following EAC's acquisition of Heidelberg, Heidelberg expanded its product line to handle other equipment which was complementary to the HDM presses. This other equipment included lines of paper cutters and folding equipment manufactured by two unrelated German corporations, Polar Mohr and Stahl GMBH & Co. EAC and its Danish parent, EAC,

Ltd., played an influential role in helping Heidelberg obtain the licenses to distribute these products.

Heidelberg conducted its importing and distributing of printing presses and related equipment through its Graphics division. Heidelberg also had a second division, known as Informatics, which was involved in the development and sale of computer software for use in the printing industry.

Heidelberg and EAC shared several offices and directors. From May 1983, the same individual served as president of both companies. Additionally, at all times relevant herein, the same individual, Karsten Hess, served as secretary of Heidelberg and as secretary-treasurer and vice president of EAC. Mr. Hess was the chief financial officer of both corporations but was on EAC's payroll. Other individuals held positions as officers, managers and directors of both corporations at the corporate management level. Some administrative staff of one corporation performed services on behalf of the other. At the corporate management level, several employees transferred freely from one company to the other.

At all times relevant herein, EAC required Heidelberg to follow a uniform budgeting procedure. Mr. Hess, the chief financial officer of EAC and Heidelberg, established all fundamental financial assumptions to be used in budgeting and strategic planning (e.g., rates of inflation, rates of exchange). The budget process required each profit center within EAC, including Heidelberg, to set goals within its individual markets.<sup>2</sup> The manager of each profit center was responsible for the development of that profit center's individual strategic plan. The budget plans for the individual profit centers were then submitted to EAC corporate management for review, and were consolidated for presentation to EAC's parent, EAC, Ltd.

Although EAC and Heidelberg handled distinctly different products, management of each corporation required certain skills common to international trade. Both companies required expertise in international and import finance, including contacts with domestic and foreign lenders,

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<sup>2</sup>In addition to Heidelberg, the other profit centers were the various divisions of EAC.

knowledge of currency markets, familiarity with ocean-going transportation, and knowledge of customs laws.

At the time Heidelberg was organized in 1971, it was unable to obtain credit on the same terms as available to EAC. It did have a line-of-credit relationship with one lender which Heidelberg had continued following the demise of Old Heidelberg. EAC found the terms of this line of credit to be unacceptable. When the lender refused to give Heidelberg credit terms comparable to EAC's, EAC terminated the line of credit. EAC subsequently took over responsibility for Heidelberg's relationship with lenders and continued to manage such relationships throughout the period at issue.

At all times relevant herein, EAC maintained several lines of credit under its own name, under which borrowings were regularly made to finance inventory purchases made by Heidelberg and the various EAC divisions.<sup>3</sup> These borrowings, which were structured in the form of bankers' acceptances or letters of credit, were secured by an interest in the inventory. In order to give the bank a security interest in its inventory, Heidelberg, acting through Mr. Hess and his EAC subordinates, would transfer title documents, such as bills of lading, to EAC, which would then transfer such documents to the lending institution. The lending institution would then return the documents to EAC along with a trust receipt which enabled Heidelberg to take possession of the inventory. These lines of credit were "revolving" or "self-liquidating", meaning that

repayment was made from the proceeds of the sale of the goods purchased. The interest rates for such secured loans were lower than for unsecured loans.

In effect, EAC regularly borrowed on its own lines of credit to finance inventory purchases made by Heidelberg, with the lending institutions securing their loans with security interests in that inventory. Generally, EAC's lines of credit were used to finance inventory

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<sup>3</sup>Heidelberg and the EAC divisions made inventory purchases by contracting with specific suppliers directly.

purchases made by Heidelberg or any of the EAC divisions. During the relevant period, EAC maintained two accounts which were used exclusively to finance Heidelberg inventory purchases. Heidelberg also obtained a line of bank financing in its own name in order to finance the import of inventory manufactured by a British supplier.

One lending institution, Credit Lyonnais, issued letters of credit for the import of Heidelberg equipment. These documents indicated on their face that Heidelberg was the borrower; however, those letters were, in fact, issued on EAC's line of credit.

Both EAC and Heidelberg obtained working capital financing to cover the operating costs of importing and distribution. Working capital needs were generally financed by unsecured lines of credit and uncommitted funds available in the concentration account (see, Finding of Fact "23"). EAC maintained a number of lines of credit to be used for working capital purposes by either EAC or Heidelberg. Heidelberg also maintained, in its own name, lines of credit for working capital purposes. These Heidelberg lines were guaranteed by EAC at the direction of the lending institution.

Heidelberg generally did not attempt to obtain inventory or working capital financing in its own name. EAC employees responsible for handling Heidelberg's credit relationship believed that Heidelberg would be unable either to obtain any or sufficient financing on its own. They also believed that, if Heidelberg could obtain such financing on its own, the terms of such financing would be unattractive relative to the terms of financing through EAC. Further, given the relationship between EAC and Heidelberg, it was not necessary for Heidelberg to obtain financing on its own.

To establish their contention that Heidelberg, on its own, would not have been able to obtain the same amount of credit as it obtained through EAC, petitioners presented the testimony of a bank officer responsible for EAC's account with Credit Lyonnais. The bank officer testified, generally, in support of petitioners' contention. The bank officer also estimated that if Heidelberg had not relied on EAC for financing, it would have experienced a credit shortfall of about \$31 million for 1983 and \$14 million for 1984. For 1983, such a shortfall

would have reduced Heidelberg's sales by about 50%. The bank officer further testified that had Heidelberg borrowed in its own name, it would have had to pay a higher interest rate than EAC, unless EAC guaranteed the loan.

The bank officer's credit shortfall estimates for 1983 and 1984 (noted above) amounted to the difference between estimates of a stand-alone Heidelberg's total lines of credit available for each of those years and Heidelberg's estimated credit needs for those years. The total lines of credit available to a stand-alone Heidelberg were based upon Heidelberg's capital base at the beginning of each of these two years multiplied by a factor of four. The capital base amounts were taken from Heidelberg's unaudited financial statements for the fiscal years ended 12/31/82 and 12/31/83. The capital base consists of capital stock, retained earnings and surplus. The factor of four by which the capital base was multiplied constitutes a generous, or a least conservative, factor according to accepted banking practices. The total credit needs figures were based upon Heidelberg's actual cost of sales for 1983 and 1984 divided by two. This formula thus assumes a six-month inventory turnover.

It should be noted that based upon petitioner's own evidence, the estimate of \$14 million credit shortfall for 1984 is in error.<sup>4</sup> The testimony and documentation submitted indicate total credit available to a stand-alone Heidelberg of \$82.4 million and total credit needs of \$96 million, thereby resulting in the (approximate) \$14 million credit shortfall for 1984. According to the evidence presented regarding the formulas used to calculate those figures, however, this total credit needs figure is incorrect. As noted above, total credit needs was determined by dividing cost of sales by two. For 1984, Heidelberg's cost of sales was \$137.6 million. Using petitioner's formula, Heidelberg's total credit needs for 1984 amounted to \$68.8 million and not \$96 million. Consequently, using this method of analysis, rather than a shortfall of \$14 million for 1984, a stand-alone Heidelberg would have had a "credit surplus" of about \$13.8 million.

In order to achieve the most efficient use of funds, EAC and Heidelberg used an

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<sup>4</sup>The credit shortfall of \$31 million for 1983 is correct as are the credit shortfall estimates for prior years.

integrated cash management system. At the core of this system was a "concentration" account maintained in EAC's name at Citibank in New York City. Additionally, each of EAC's profit centers, including Heidelberg, maintained "lock-box" and disbursement accounts at various locations around the country. These accounts were linked to the concentration account. All funds received by EAC and Heidelberg were channeled into the concentration account, including the proceeds of loans for inventory or working capital financing and payments from customers sent to the various lock-box accounts. EAC and Heidelberg maintained records of each company's contributions to and deposits from the concentration account. Within the concentration account, however, all funds were commingled.

EAC maintained a uniform system for paying Heidelberg's suppliers. Heidelberg's purchases were arranged so that payments came due at a date in the middle of the month when currency prices were expected to be most stable. In advance of that date, Mr. Hess assembled a schedule of payments due, and purchased foreign currency in appropriate amounts. All payments for such foreign currency purchases came out of the concentration accounts. The banks supplying foreign currency were directed to remit the funds to appropriate accounts in Europe maintained by EAC. In some cases, the funds were transferred directly to accounts maintained by Heidelberg's suppliers. Payments for German suppliers were all routed to a Deutsche mark concentration account maintained by EAC with a German bank. The German bank then transferred payments to individual suppliers' banks in Germany.

The concentration account was also used to fund all day-to-day cost needs of the EAC divisions and Heidelberg. At appropriate times, funds were transferred from the concentration account to disbursement accounts maintained by the various profit centers at various locations throughout the country. Apart from relatively small operating reserves, the profit centers kept no funds on hand; all excess funds were transferred to the concentration account.

Since all funds were commingled in the concentration account, the proceeds of loans secured by Heidelberg's inventory (see Finding of Fact "15") were used from time to time to



fund EAC's operations. Conversely, funds generated by EAC were, from time to time, used to fund Heidelberg's operations. As noted previously, the books and records of EAC and Heidelberg accounted for all deposits into the concentration accounts as well as transfers therefrom.

The cash management system operated by EAC, in effect, served as a bank in relationship to the various profit centers. Through this system, the profit centers, including Heidelberg, borrowed from the concentration account rather than directly from lenders. EAC charged interest on such borrowings monthly at a rate equal to its overall monthly cost of funds, without any additional points or fees.

The different business cycles of Heidelberg and EAC's Plumrose division (EAC's biggest division), coupled with the cash management system, also allowed EAC and Heidelberg to operate more efficiently. Heidelberg experienced its strongest demand in the fourth quarter of the year and therefore needed to build up inventory during the third quarter to meet that demand. Plumrose experienced its strongest demand in the second and third quarters, and therefore experienced its strongest cash flow in those quarters. Since both Heidelberg and Plumrose were part of the same cash management system, Plumrose's business cycle helped to reduce Heidelberg's borrowing needs.

The printing presses and graphic arts equipment sold by Heidelberg are expensive items. Third-party customer financing was therefore essential to Heidelberg's business since Heidelberg's customers generally could not purchase these products without financing and Heidelberg could not afford to provide financing on its own. During the audit period, Heidelberg relied on two financing companies, CIT Corporation and Litton Capital. CIT handled the majority of Heidelberg's sales and it required that EAC guarantee Heidelberg's installment sales contracts. EAC provided that guarantee, without charge, and that guarantee remained in effect until the two companies merged in 1985. Litton did not require an EAC guarantee. Litton did, however, exercise more control over the relationship, performing individual credit checks on Heidelberg's customers before agreeing to finance their purchases.

CIT required Heidelberg to provide it with separate financial statements, in addition to the consolidated financial statements of EAC. CIT also expressed a concern about Heidelberg's practice of distributing all profits to EAC each year as dividends. In response, Heidelberg agreed to distribute only 50% of its profits, beginning in 1982, and that practice continued until Heidelberg and EAC merged in 1985.

Both before and during the audit period EAC and Heidelberg purchased insurance coverage on a combined basis. This practice resulted in considerable savings to both companies, and also enabled EAC to qualify for "loss-rated coverage", by which the companies' aggregate premiums were adjusted to reflect the actual loss experience of all members of the group. The insurance broker for EAC and Heidelberg testified that in 1983 and 1984, the two companies saved approximately \$1.1 million by purchasing insurance on a combined basis, thereby qualifying for "loss rating" and volume discounts. During the audit period, the insurance broker had provided EAC with a breakdown of insurance costs by profit center; however, that breakdown was based on actual costs and did not reflect savings which were achieved by joint purchases.

The two companies also purchased a variety of other services from third parties on a combined basis. The same independent accountants served both companies and the same attorneys served as outside counsel for both. A single in-house counsel served both companies. Additionally, the two companies purchased the rental of their automobile fleet on a combined basis. The fleet was used primarily by Heidelberg employees and the management of the fleet was handled by Heidelberg employees. EAC did use the fleet, but was not charged for this fleet management service. All profit centers were charged the specific costs of each center's car rental activities. Generally, the two companies were able to lower their costs by purchasing services on a combined basis.

EAC and Heidelberg gave each other assistance in connection with real property transactions. In every significant real property transaction, Heidelberg was required to provide EAC's guarantee to obtain third-party financing. Heidelberg owned facilities in Glendale, New

York; Georgia and Michigan. EAC guaranteed Heidelberg's obligations in connection with the New York and Georgia facilities, and acted as advisor in connection with the acquisition of the Michigan facility. Heidelberg personnel assisted EAC in certain real estate transactions, including leases of real property in Oakland, California and Springfield, New Jersey. Neither company charged the other for services rendered in connection with these services.

During the audit period, many of the personnel operations of the two companies were unified. The same individuals were responsible for personnel management, labor negotiations, health benefits for non-union employees, pension benefits<sup>5</sup>, real estate and office facility management. In most cases, these individuals were employees of Heidelberg; EAC did not pay or contribute to the cost of these individuals' services. Payrolls were administered for both corporations by an outside firm and were paid out of the concentration account. The two corporations maintained separate personnel policy manuals. While there was some degree of coordination in policy, the manuals differed in areas related to collective bargaining agreements.

Within the corporate management of both companies, individual employees were able to, and did, transfer freely from one company to another. Transferring employees retained all seniority and benefits they had enjoyed in their former positions.

EAC and Heidelberg also sought to coordinate their trucking activities. Where feasible, trucks used by EAC to transport Plumrose meat products were used to carry Heidelberg inventory on their return trips, rather than return empty. Employees of the two companies responsible for this program communicated on a weekly basis to determine whether this coordinated arrangement was feasible for that week and, if so, to make the necessary arrangements. Heidelberg paid EAC for this service at normal contract carrier rates.

Heidelberg also produced, without charge, certain printing materials for EAC Plumrose.

Although Heidelberg's outside accountants prepared unaudited financial statements for

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<sup>5</sup>The pension committee, which oversaw the administration of the pension plans, was comprised of officers of EAC and Heidelberg and delegates from each of the profit centers.

Heidelberg in 1983 and 1984, these specifically stated that Heidelberg's financial position could be fairly stated only when the consolidated financial statements of EAC and its subsidiaries were taken into account.

Heidelberg's outside accountant testified that its financial statements were unreliable when viewed in isolation, due to the lack of intercompany charges or other provisions reflecting the substantial services performed by each company for the other, including managerial, financial, and administrative services. In addition, the accountant testified that separate financial statements did not reflect the considerable savings achieved through consolidated borrowing and joint purchasing of outside services such as insurance, legal and accounting services, and transportation services. Although certain costs which were traceable to payments made to third parties were charged back from one company to the other, Heidelberg's financial statements did not reflect the contributions each company made to the business of the other.

In June 1985, the two companies merged. The management of EAC and Heidelberg had long been interested in merging, and had refrained from doing so primarily because HDM, Heidelberg's principal supplier, wished to maintain the "Heidelberg" name. This objection was finally resolved by a reverse merger, in which Heidelberg was the surviving corporation. After the merger, the new company continued to function in exactly the same way as it had when there were two separate corporations.

Heidelberg and EAC filed New York State franchise tax reports on a combined basis during the period at issue, i.e., 1983, 1984 and January 1 through June 30, 1985. By letter dated February 29, 1984, petitioners requested permission to file on a combined basis for periods commencing January 1, 1983. The record contains no evidence indicating that petitioners were ever granted tentative permission to file on a combined basis for the period at issue. Petitioners had been granted tentative permission to file combined reports in the period 1973 through 1982. On field audit herein, the Division of Taxation ("Division") determined that combined filing was not appropriate under relevant statutes and regulations. At hearing, the Division's auditor testified that he had determined that combined reports should not be permitted because the two

companies were not part of a unitary business, and because there were not substantial intercorporate transactions between the companies. The auditor testified that he concluded the two companies were not part of a unitary business because they handled different products and that the absence of substantial intercorporate transactions ruled out combined reporting.

Following the field audit, the Division issued to Heidelberg ten notices of deficiency under Article 9-A of the Tax Law, each dated March 31, 1989. Said notices asserted tax due as follows:

<u>Period Ended</u>	<u>Tax</u>	<u>Amount</u>
12/31/83	Corporation Franchise	\$ 229,726.00
12/31/83	Metropolitan Transportation Bus. Tax Surcharge	37,015.00
12/31/84	Corporation Franchise	965,845.00
12/31/84	Metropolitan Transportation Bus. Tax Surcharge	164,073.00
12/31/85	Corporation Franchise	21,681.00
12/31/85	Metropolitan Transportation Bus. Tax Surcharge	8,452.00
12/31/85	License Fee	6,025.00
12/31/86	Corporation Franchise	36,250.00
12/31/86	Metropolitan Transportation Bus. Tax Surcharge	7,462.00
12/31/86	License Fee	<u>52.00</u>
Total Tax Due		\$1,476,581.00

The Heidelberg notices (except those asserting the license fee) also asserted penalties and interest. The field audit report indicated that penalties were asserted pursuant to Tax Law § 1085(b)(1) and (2) based upon Heidelberg's "unauthorized inclusion" in combined reports.

Following the field audit on April 11, 1989, the Division issued to EAC three notices of deficiency in amounts as follows:<sup>6</sup>

<u>Period Ended</u>	<u>Tax</u>	<u>Amount</u>
6/30/85	Corporation Franchise	\$11,422.00
6/30/85	Metropolitan Transportation Bus. Tax Surcharge	1,845.00
6/30/85	License Fee	<u>677.00</u>
Total Tax Due		\$13,944.00

EAC and Heidelberg each subsequently filed petitions in this matter. Both petitioners

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<sup>6</sup>The Division also issued to EAC notices of deficiency in respect of the periods ended 12/31/80 and 12/31/81. Disputes regarding these notices were apparently resolved prior to hearing.

identified the principal issue herein as whether Heidelberg and EAC should be permitted to file combined reports. At hearing, petitioners raised certain additional issues concerning the proper treatment of certain promissory notes and leasehold improvements. By letter dated August 9, 1991, petitioners withdrew their objection to the treatment of leasehold improvements. In their post-hearing brief, petitioners withdrew their objection to the treatment of the promissory notes. Thus the only remaining substantive issue is whether petitioners should be permitted to file combined reports for 1983 through June 30, 1985.

The Heidelberg field audit report indicated that \$1,053,749.00 of the additional tax asserted against Heidelberg was attributable to the Division's denial of permission to file combined reports and recomputation of Heidelberg's franchise tax liability on a separate basis. The EAC field

audit report indicated an adjustment in respect of the combined filing disallowance which lowered EAC's tax liability by \$88,781.00.

Petitioners filed consolidated Federal corporation income tax returns throughout the period at issue.

Petitioners submitted proposed findings of fact numbered "1" through "37". Said proposed findings are, generally, accepted and have been incorporated into the Findings of Fact herein.

#### CONCLUSIONS OF LAW

A. The filing of combined reports for corporation franchise tax purposes is authorized by Tax Law § 211(4), which, during the period at issue provided, in part, as follows:

"In the discretion of the tax commission, 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[,] . . . 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, however, 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. Regulations promulgated under Tax Law § 211(4), effective for all taxable years ending on or after December 31, 1983, provide that combined reports shall be permitted where the corporations in the group meet the capital stock requirement (20 NYCRR 6-2.2[a]), unitary business requirement (20 NYCRR 6-2.2[b]) and the "other requirement" (20 NYCRR 6-2.3) set forth in the regulations (see, 20 NYCRR 6-2.1).

C. Since at all times relevant herein Heidelberg was a wholly-owned subsidiary of EAC, the capital stock requirement has been met (20 NYCRR 6-2.2[a]). It is noted that the Division conceded this point.

D. The regulations provide the following guidance with respect to the unitary business requirement:

"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;
- "(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.

"(3) Examples:

"Example 2:

"A manufacturing corporation organizes an 80 percent or more owned subsidiary and transfers all of its selling activities to the subsidiary. The subsidiary sells only the parent's products for which it receives a commission. The subsidiary has a place of business of its own and its own employees. The corporations are conducting a unitary business.

"Example 3:

"The taxpayer, a manufacturing corporation, forms a holding company which is also subject to tax. The holding company owns all of the manufacturing company's stock. The only activity of the parent holding company is to receive dividends from the manufacturing corporation. The corporations are not conducting a unitary business." (20 NYCRR 6-2.2[b].)

E. The unitary business concept in Federal constitutional law developed in response to the states' authority to devise formulas to accurately assess a corporation's intrastate value or income, and to limit the states' authority to tax a corporation's value or income not attributable to the taxing state (Allied-Signal, Inc. v. Director, Div. of Taxation, \_\_\_ US \_\_\_, 119 L Ed 2d 533 [June 15, 1992]). In recent cases the Tax Appeals Tribunal has applied the Supreme Court's unitary business standard to issues arising under Article 9-A of the Tax Law (see, Matter of USV Pharmaceutical Corp., Tax Appeals Tribunal, July 16, 1992 [combination issue]; Matter of British Land [Maryland], Ltd., Tax Appeals Tribunal, September 3, 1992 [allocation percentage issue arising under Tax Law § 210(8)]).

In Matter of British Land (Maryland), Ltd. (*supra*) the Tribunal summarized the current status of the unitary business principle:

"The constitutional prerequisite to an acceptable finding of unitary business is a flow of value (Container Corp. of Am. v. Franchise Tax Bd., 463 US 159, 178). The constitution test focuses on functional integration, centralization of management and economies of scale (Allied-Signal, Inc. v. Director, Div. of Taxation, *supra*, 112 S Ct 2251, 2252, 2261). In Allied-Signal, the Supreme Court recently clarified the meaning and application of these factors by stating that these essentials could respectively be shown by: transactions not undertaken at arm's length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business (Allied-Signal, Inc. v. Director, Div. of Taxation, *supra*, 112 S Ct 2251, 2264). The Allied-Signal decision credits the decision in Container as having identified these factors as evidence of a unitary business and cites to specific parts of the Container decision for each factor. The citations are instructive in understanding the factors and applying them to the instant facts.

"First, with respect to the non-arm's length transaction, the Court in Allied-Signal identified this as an element to prove functional integration and referred to that part of its Container decision where it noted that there was a flow of capital resources from Container to its subsidiaries through loans and loan guarantees, which were not shown to be at arm's length and which obviously resulted in a flow of value (Allied-Signal, Inc. v. Director, Div. of Taxation, *supra*, 112 S Ct 225, 2264, citing Container Corp. of Am. v. Franchise Tax Bd., *supra*, at 180, n. 19). The Container decision also stated that a capital transaction can serve either an



investment function or an operational function and concluded that Container's capital transaction served an operational function -- to ensure the continued growth and profitability of the subsidiaries (Container Corp. of Am. v. Franchise Tax Bd., supra, at 180, n. 19)."

F. A review of the record herein in light of the relevant regulatory and case authorities compels the conclusion that petitioners were engaged in a unitary business during the period at issue within the meaning of 20 NYCRR 6-2.2(b).

As noted previously, the key to a finding of a unitary business is a flow of value from one corporation to another. In the instant matter, this flow of value is most clearly manifest in EAC's management of Heidelberg's access to credit and its relationship with lenders. Heidelberg's inventory financing was obtained almost exclusively through EAC lines of credit. Under Mr. Hess's supervision, EAC managed Heidelberg's inventory financing, which involved the transmittal to the lender of various title documents each time such financing was arranged. EAC and Heidelberg also jointly obtained working capital financing. EAC thus facilitated a flow of capital resources to Heidelberg. This flow of capital "obviously resulted in a flow of value" (Container Corp. of Am. v. Franchise Tax Bd., supra, at 180, n. 19). EAC's guarantees on behalf of Heidelberg in the areas of customer financing, real property transactions, and inventory and working capital financing also resulted in a flow of value (id.).

Also strongly indicative of a unitary business was the cash management system under which all incoming funds (whether loan proceeds or receivables) were comingled in the concentration account. These funds were then disbursed as necessary to the various profit centers or as payments were made to various suppliers of EAC and Heidelberg. Under the cash management system the profit centers were charged interest based upon the overall cost of funds. This system integrated the cash management functions of EAC and Heidelberg, taking advantage, to the extent possible, of the differing business cycles of Heidelberg and Plumrose. Further, the cash management function required day-to-day involvement and is clearly grounded in EAC's "operational expertise". EAC's cash management on behalf of Heidelberg thus goes well beyond the "occasional oversight . . . that any parent gives to an investment in a subsidiary" (F. W. Woolworth Co. v. Taxation and Revenue Dept. of State of New Mexico, 458 US 354,

369, 73 L Ed 2d 819).

Also indicative of centralization at the management level between EAC and Heidelberg was their use of a single budgeting process; the same outside attorneys and accountants; the use of a single in-house counsel; the transfer of employees between the two corporations at the corporate management level; the joint purchase of insurance; a unified pension plan; a unified health insurance plan; a single vehicle fleet; and the coordination of operations in Heidelberg's use of Plumrose vehicles where possible. Also noteworthy is the fact that from May 1983, the same individual served as president of both corporations. Furthermore, this individual and the chief financial officer of EAC and Heidelberg, were drawn from the ranks of EAC's Danish parent (cf., F. W. Woolworth Co. v. Taxation and Revenue Dept. of State of New Mexico, supra, at 366).

In sum, the record herein is replete with evidence of a unitary business. While Heidelberg and EAC sold distinctly different products there was clearly an "umbrella of centralized management and controlled interaction" between the two corporations (see, Exxon Corp. v. Wisconsin Dept. of Revenue, 447 US 207, 224, 65 L Ed 2d 66, 81) and through this centralized management each engaged in activities related to the other (20 NYCRR 6-2.2[b][1]). Accordingly, it must be concluded that petitioners were engaged in a unitary business.

G. Turning next to the distortion of income requirement, the Division's regulations at 20 NYCRR 6-2.3<sup>7</sup> provide, in part, as follows:

"Other requirement. (a) If the capital stock and unitary business requirements described in section 6-2.2 of this Part have been met, the Tax Commission may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations.

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<sup>7</sup>The Division's current regulation on the distortion issue, 20 NYCRR 6-2.3, became effective June 26, 1984. Since petitioners' report for the year ended December 31, 1983 was filed on October 19, 1984, this regulation was in effect at the time of such filing and therefore is applicable herein to the entire period at issue.

\* \* \*

"(d) If a taxpayer fails to meet the presumption of distortion because it does not have substantial intercorporate transactions with any corporation described in section 6-2.2 of this Part or with a combined or combinable group of such corporations and if the filing of a report on a separate basis nevertheless results in a distortion of such taxpayer's activities, business, income or capital in New York State then the Tax Commission will permit or require the filing of a combined report. If a taxpayer meets the presumption of distortion because it has substantial intercorporate transactions with any corporation described in section 6-2.2 of this Part or with a combined or combinable group of such corporations and if the filing of a report on a separate basis does not result in a distortion of such taxpayer's activities, business, income or capital in New York State, then the Tax Commission will not permit or require the filing of a combined report."

H. "The unitary business test and the distortion of income test are, in fact, interrelated factors" (Matter of Autotote Limited, Tax Appeals Tribunal, April 12, 1990). Indeed it is the existence of factors which, taken together, constitute a unitary business that give rise to or cause distortion of income. This interrelatedness of the various tests in respect of combination is well established and is best summarized as follows:

"[T]he ultimate question is whether, under all of the circumstances of the intercompany relationship . . . combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income. In answering this question, no single factor is decisive (Matter of Coleco Inds. v. State Tax Comm., *supra*, 92 AD2d 1009, 461 NYS2d 462)" (Matter of Standard Mfg. Co. v. Tax Commn. of State of New York, 114 AD2d 138, 498 NYS2d 724, *affd* 69 NY2d 635, 511 NYS2d 229).

I. Petitioners do not assert that there were "substantial intercorporate transaction" between them during the period at issue (*see*, 20 NYCRR 6-2.3[b], [c]). While the absence of such transactions does not preclude a finding of distortion (*see*, 20 NCYRR 6-2.3[d]), petitioners are not entitled to the presumption of distortion provided by the regulations where substantial intercorporate transactions exist (*id.*). Petitioners therefore bear the burden of proving distortion during the period at issue.

J. Upon review of the record herein, it is concluded that petitioners have established that the filing of franchise tax reports on a separate basis would distort petitioners' true income and tax liability.

As noted above, the same factors which result in a finding of a unitary business tax may

also result in income distortion if separate reporting is required. The relationship between these two factors may be seen in Container Corp. of America v. Franchise Tax Bd. (*supra*) wherein the Court stated that the fundamental characteristic of a unitary business is "some sharing or exchange of value not capable of precise identification or measurement" (*id.* at 166 [emphasis supplied]). It is the inability to measure exchanges of value from one corporation to another which constitutes distortion.

In the instant matter, distortion may be seen in EAC's management of Heidelberg's access to credit and its relationship with lenders. It is undisputed that, as a result of its relationship with EAC, Heidelberg's access to financing was greatly increased and that much of this financing was obtained through EAC credit lines. Where Heidelberg obtained financing through its own name, EAC guaranteed Heidelberg's obligation. EAC personnel managed Heidelberg's inventory financing. As noted previously, these activities by EAC facilitated the flow of capital to Heidelberg and clearly resulted in value to Heidelberg. EAC was not compensated for this value. The income of both petitioners is therefore distorted to the extent that Heidelberg benefitted from the activities of EAC but did not compensate EAC for such activities.

The cash management system utilized by EAC and Heidelberg also resulted in distortion. Specifically, this system, including the payment of suppliers, was managed by EAC personnel and EAC received no compensation from Heidelberg for this service. Additionally, both EAC and Heidelberg benefitted from the concentration account cash management system. Under this system the borrowing needs of both corporations were lower than they would have been under separate cash management. This savings resulted, in part, from the differences in business cycles of the two corporations; at the time when Heidelberg needed cash to build up its inventory, EAC had its strongest cash flow. Cash flow generated by EAC was available for Heidelberg's use thereby reducing borrowing needs.

Additionally, the record herein establishes that EAC was able to command more favorable borrowing rates than Heidelberg. Consequently, most financing was obtained under

EAC's name, deposited in the concentration account, and disbursed as needed to Heidelberg or its suppliers. EAC charged Heidelberg interest based on EAC's overall cost of funds.

Consequently, through its relationship with EAC Heidelberg was able to pay lower interest costs than it would have absent its relationship with EAC. EAC was not compensated by Heidelberg for this benefit and the increased interest costs to a stand-alone Heidelberg would not be reflected on separate basis reports.

The functional integration of petitioners at the management level also benefitted both corporations. As discussed, the corporations operated under a single financial management system. Additionally, petitioners also integrated their budgeting, corporate management and strategic planning. Additionally, insurance, transportation, personnel, health insurance, and labor relations matters were integrated. The savings engendered by such integration would not be reflected in separate basis reports and would therefore result in distortion of income. Finally, it is noted that EAC management personnel aided Heidelberg in obtaining necessary licenses to expand its product line. This action added to Heidelberg's profitability and would not be reflected in separate reports.

K. Having met the capital stock, unitary business and distortion tests, it must be concluded that the Division's refusal to permit petitioners to file combined reports was in error.

L. With respect to the penalty issue, the sole rationale articulated by the Division for the imposition of such penalties was Heidelberg's purportedly improper filing of combined reports with EAC. Since the combination issue has been resolved in Heidelberg's favor, the Division's rationale for the imposition of penalties is no longer available. Accordingly, the Division is directed to cancel penalties and penalty interest imposed upon any remaining taxes owed or owing by Heidelberg in respect of the notices of deficiency listed in Findings of Fact "42" and "44".

M. The petitions of Heidelberg Eastern, Inc. and East Asiatic Company, Inc. are granted to the extent indicated in Conclusions of Law "K" and "L". The Division is directed to recompute petitioners' remaining tax liability for the periods at issue on a combined filing basis

in accordance therewith. As recomputed, the notices of deficiency herein are sustained.

DATED: Troy, New York  
February 11, 1993

/s/ Timothy J. Alston  
ADMINISTRATIVE LAW JUDGE