STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
BIG V SUPERMARKETS, INC.	:	DETERMINATION DTA NO. 812066
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1987, 1988 and 1989.	:	

Petitioner, Big V Supermarkets, Inc., 176 North Main Street, Florida, New York 10921, 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 1987, 1988 and 1989.

On March 17, 1994, petitioner and the Division of Taxation filed a fully executed consent to waive a hearing and have this controversy determined on submission of documents. The parties submitted documents, including a stipulation of facts, on April 26, 1994. Both parties submitted briefs. Petitioner submitted a reply brief on September 29, 1994 which began the six-month statutory period for issuance of a determination. Petitioner appeared by Russell W. Banigan, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Robert Tompkins, Esq., of counsel).

After consideration of the documents and briefs, Jean Corigliano, Administrative Law Judge renders the following determination.

ISSUES

I. Whether "patronage dividends" as defined in section 1388 of the Internal Revenue Code are properly classified as investment income under Tax Law § 208.6.

II. Whether, if patronage dividends are properly classified as business income, petitioner's business allocation percentage should be calculated by including a share of the property, receipts and wages of the New Jersey cooperative that paid the patronage dividends.

III. Whether patronage dividends are eligible for the dividend exclusion provided in Tax Law

§ 208.9(a)(2).

FINDINGS OF FACT

Petitioner, Big V Supermarkets, Inc. ("Big V"), and the Division of Taxation ("Division") entered into a stipulation which included stipulated facts, stipulations concerning the authenticity of certain documents, and stipulations of agreement to certain issues. The stipulated facts and other relevant stipulations have been incorporated into these Findings of Fact.

Big V is a New York corporation which owns and operates a chain of supermarkets under the "Shop Rite" trade name primarily in the Hudson Valley Region of New York.

The Division conducted a field audit of Big V which resulted in the issuance of six notices of deficiency, each dated September 13, 1991, asserting deficiencies of tax as follows:

Year	Tax	Amount
1987	9-A	$ 18,867.00
1987	MTA	2,524.00
1988	9-A	127,585.00
1988	MTA	15,233.00
1989	9-A	178,869.00
1989	MTA	24,340.00

The Division issued a Conciliation Order, dated April 9, 1993, sustaining the notices of deficiency.

Big V is the largest member of the Wakefern Food Corporation ("Wakefern"), a New Jersey corporation operating on a cooperative basis for the benefit of its stockholder customers. Wakefern calculates its Federal taxable income as a cooperative corporation under sections 1381-1388 of the Internal Revenue Code.

Big V is allowed to use the Shop Rite name by permission of Wakefern as required by Article X and Article XII of Wakefern's By-Laws (the "By-Laws"). Big V does not operate supermarkets under any trade name other than "Shop Rite".

By the terms of Wakefern's By-Laws, each cooperative member is required to make an investment in the common stock of Wakefern. The amount of the investment which is required from each member is based on the number of supermarkets owned and the volume of each

store's purchases from Wakefern. Regarding the investment requirements of stockholders, Article XI of the By-Laws provide as follows:

> "The Board of Directors . . . shall have the power from time to time to determine, on a uniform basis as to all Wakefern stockholders, the ratio between the required minimum investment of each stockholder per store and each stockholder's weekly purchases per store from Wakefern and shall also have the power to determine the method of arriving at such average weekly purchases and to set minimum and maximum amounts of required investments."

During the audit years, Big V owned approximately 17% of the outstanding shares of Wakefern. The amount of its investments during each of the audit years was as follows:

1987	$24,000,000.00
1988	22,745,225.00
1989	22,745,198.00

During the audit years, the total value of Big V's assets was as follows:

1987	$211,058,628.00
1988	175,379,298.00
1989	167,810,342.00

During the audit years, Big V's net worth was as follows:

1987	$22,400,060.00
1988	12,655,408.00
1989	11,223,371.00

Under the terms of a Warehouse Agreement, expiring September 1, 2000, Big V is obligated to purchase at least 85% of its merchandise requirements from Wakefern and did so in 1987, 1988 and 1989.

Under Article XIX of the By-Laws, all Wakefern stockholders are "patrons" as that term is defined by the Treasury Regulations of the Internal Revenue Code. The difference between prices charged to stockholder members on their inventory orders and the discounted prices paid by Wakefern on volume purchases creates the earnings of Wakefern. At the end of its fiscal year, Wakefern distributes to its members the net earnings of each product department of Wakefern. Article XIX provides, as pertinent here:

> "[T]he Board of Directors shall distribute as a 'patronage dividend' to each stockholder a share of the net earnings of each product department of Wakefern during each fiscal year, in proportion to the value (i.e., dollar volume) of business done by the stockholder with each product department of Wakefern during that fiscal year, so that all of said net earnings of Wakefern resulting from business

done with its patrons during each fiscal year (otherwise termed 'patronage') are distributed; provided, however, that if there is a net loss in one (1) or more of the product departments of Wakefern, each patron will be charged with a portion of that loss, in proportion to the value of business done by said patron with the appropriate product department, or as the Board of Directors shall otherwise determine." (Emphasis in original.)

As stated in Article XIX of the By-Laws, net losses suffered by Wakefern can be assessed against Wakefern's patrons. As an illustration, in 1993 Big V was assessed $405,000.00 by Wakefern as its share of costs suffered by Wakefern during labor strikes against various Wakefern patrons.

During the audit years, Big V received patronage dividends from Wakefern as follows:

Year	Amount
1987	$ 877,406.00
1988	2,961,591.00
1989	3,076,882.00

For Federal income tax purposes, Big V reported the patronage dividends it received from Wakefern on Schedule C, Form 1120 as "other dividends", not eligible for Federal dividend exclusions. This treatment is consistent with the rules for tax treatment of patronage dividends found in IRC §§ 1381-1388.

Big V filed New York State corporation franchise tax reports for the audit years, classifying all or part of the patronage dividends as investment income, as follows:

YEAR	PATRONAGE DIVIDEND REPORTED AS INVESTMENT INCOME	PERCENT OF TOTAL PATRONAGE DIVIDEND
1987	$ 877,406.00	100%
1988	1,480,795.00	50%
1989	2,461,220.00	80%

No dividend exclusion was claimed on Big V's New York corporation franchise tax reports for any of the patronage dividends received.

Big V accrues an estimate of its expected patronage dividend for book income. By the time the tax return for a given year is prepared, Big V has learned the correct patronage dividend for that year and reports that amount on its Federal and State tax returns.

In the years preceding the audit years, Big V classified none of the patronage dividends it received as investment income.

On audit, the Division determined that the patronage dividends were a form of rebate which should have been classified as a reduction of the cost of goods sold, similar to a purchase discount or allowance. The Division eliminated the amount of the patronage dividends from Big V's investment income and recomputed its investment allocation percentage accordingly. For the years 1987, 1988 and 1989, the Division calculated investment allocation percentages of .1828%, .0020% and .1338%, respectively.

The Division reclassified as business income that portion of the patronage dividends reported by Big V as investment income. The Division recomputed Big V's business allocation percentages, arriving at percentages of 95.6954%, 95.1678% and 94.2541% for the years 1987, 1988 and 1989, respectively. The amount of the patronage dividends was not included in the calculation of the business allocation percentages.

The Division made several other adjustments to Big V's corporation franchise tax reports. Big V's investment tax credit was decreased, it was allowed to file on a combined basis with its sole subsidiary, Big V Properties, Inc., and its employment incentive credit was recomputed. The only audit adjustment in dispute in this proceeding is the reclassification of the patronage dividends as business income.

In an affidavit, Florence Engel, a supervising corporation tax auditor, stated that the Division conducted an audit of Wakefern for the fiscal years ended October 1, 1988, September 30, 1989 and September 29, 1990. According to Ms. Engel, the audit revealed that Wakefern deducted from its gross income the amount of the patronage dividends paid to its shareholders.[1]

The parties to the dispute agree that the entire amount of the patronage dividends reported by Big V on its Federal income tax returns for

the subject years should be treated as either business or investment income as determined by the Division of Tax Appeals.

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[1]Petitioner initially objected to having this affidavit admitted into evidence but later withdrew its objection.

The Division has never promulgated any regulations, advisory opinions, or other documents regarding the treatment of patronage dividends.

The New York State Department of Taxation and Finance has never promulgated any regulations, advisory opinions or other documents defining the term "dividend".

During the course of the audit, Big V requested, as an alternative to treating patronage dividends as investment income, a modification of Big V's business allocation percentage "to reflect its prorata portion of Wakefern's property, payroll and receipts" (Letter from Anthony J. Melfi, May 16, 1991).[2] The Division did not recompute Big V's business allocation percentage as requested.

Absent Big V's relationship with Wakefern, Big V would be required to replace the inventory purchasing function which it now relies on Wakefern

to perform. For example, it would be necessary for Big V to establish facilities (warehouses, personnel, purchasing networks, etc.) to perform the purchasing function or to join another cooperative organization that purchases inventory for its members. The preferred alternative would enable Big V to realize the same economic benefits (i.e., economies of scale) or detriments which it receives from Wakefern.

"If Big V is permitted to include in its property and payroll ratios its prorata share (based

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[2]Paragraph 22 of the Stipulation states that "Big V requested the auditors from the [Division] exercise their discretion . . . to modify Big V's property and payroll ratios of the business allocation percentage to include Big V's prorata share of Wakefern's property and payroll." However, in three letters submitted to the Division on March 7, 1991, May 16, 1991 and November 11, 1992 (Stipulation, ¶ 23), Big V included Wakefern's business receipts as one of three factors to be used in modifying its own business allocation percentage. In its brief, petitioner's representative requested that Wakefern's business receipts be included in the allocation formula. The Division noted the discrepancy between the stipulation and the brief and stated: "Petitioner apparently seeks to abandon its agreement in Stip par. 22 and resurrect the receipts request contained in the letters attached to its petition." Unfortunately, the stipulation does not reflect an agreement by petitioner to abandon its original request. Paragraph 22 merely states that petitioner asked the auditors to modify the property and payroll ratios. If the deletion of any reference to business receipts was intended by the parties to reflect an agreement, that agreement should have been made explicit.

on percentage [of] ownership) of Wakefern's property and payroll, the 1987, 1988 and 1989 franchise tax assessments could be reduced. Although both parties anticipate a reduction would result, no calculation has been performed at the time of this stipulation agreement. Such calculation will be performed on remand of this matter to the Division of Taxation (if so ordered by the Division of Tax Appeals)." (Stipulation, ¶ 21.)

Wakefern's issuer allocation percentages are:

Year	Percentage
1987	19.99%
1988	19.08%
1989	18.27%

CONCLUSIONS OF LAW

A. The Internal Revenue Code provides special tax treatment for any corporation operating on a cooperative basis (Subchapter T of the Internal Revenue Code). The most significant aspect of the Internal Revenue Code's treatment of cooperatives is the deduction of so-called "patronage dividends" from the cooperative's gross income.[3] Patronage dividends are defined as:

"an amount paid to a patron by [a cooperative organization]:

"(1) on the basis of quantity or value of business done with or for such patron;

"(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

"(3) which is determined by reference to net earnings of the organization from business done with or for its patrons" (IRC § 1388[a]).

The parties agree that the distributions received by Big V from Wakefern were patronage dividends as defined in the Internal Revenue Code. Their point of disagreement is whether the

[3]Although some court decisions speak of a patronage dividend as a "deduction" from gross income (see, Land O'Lakes v. U.S., 470 F Supp 238, 79-1 US Tax Cas ¶ 9380, affd in part, revd in part 675 F2d 988, 82-1 US Tax Cas ¶ 9326), others consider it an exclusion (see, Mississippi Valley Portland Cement Co. v. U.S., 408 F2d 827, 69-1 US Tax Cas ¶ 9277, n. 6, cert denied 395 US 944). Treas Reg § 1.1382-2(b) states that patronage dividends are "allowed as a deduction from the gross income of any cooperative organization." The Treasury Department's usage will be adopted here.

patronage dividends may be classified as investment income under Article 9-A of the Tax Law. Since petitioner's investment allocation percentage is much less than its business allocation percentage, permitting petitioner to treat the patronage dividends as investment income will result in a smaller tax liability.

As pertinent, investment income is defined for purposes of Article 9-A of the Tax Law as "income . . . from investment capital" (Tax Law § 208.6). Investment capital "means investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular

course of business, exclusive of subsidiary capital and stock issued by the taxpayer" (Tax Law § 208.5).

Petitioner argues that the patronage dividends represent a return on its investment in the common stock of Wakefern, and as such the patronage dividends are investment income under Tax Law § 208.6. Petitioner notes that only stockholders qualify for the patronage dividend (Article XIX of the By-Laws). Petitioner acknowledges that Wakefern's earnings were distributed based on the volume of business done by a patron, but it takes the position that a distribution of income based on a formula other than level of stock ownership does not preclude income from being classified as investment income. Petitioner also contends that the Wakefern patronage dividends were distributed based on stock ownership because each patron was required to make an investment in stock proportional to its dollar volume of purchases (Article XI of the By-Laws), and this effectively resulted in a distribution of earnings based on level of investment in Wakefern stock.

The Division's position is that patronage dividends received by a patron from a cooperative corporation are not investment income under Tax Law § 208.6. The nub of the Division's position is that a cooperative corporation is not like an ordinary corporation, and, therefore, the dividends it pays to its patrons are unlike dividends paid by an ordinary corporation to its shareholders. The Division points to four differences between a cooperative

corporation, like Wakefern, and an ordinary corporation in support of its contention that petitioner's relationship to Wakefern differs from the typical relationship between a corporation and a shareholder.

(1) As the Division explains it, Wakefern obtained a volume discount on its inventory purchases and at year's end distributed that discount to its patrons based on the volume of business done with each department. The Division characterizes the distribution of the volume discount as a rebate and states that the distribution is based on petitioner's relationship to Wakefern as a customer, rather than as an investor.

(2) The Division notes that, unlike other corporations, Wakefern is under a legal obligation to distribute its net earnings to its patrons. Thus, the Division states, petitioner is able to accrue an estimate of the expected distribution on its own books. This, the Division alleges, is different from the typical investment scenario where an investor does not know whether dividend income will be earned until the board of directors declares a dividend. The Division argues that the requirement that earnings be distributed supports its characterization of the payments as rebates.

(3) The By-Laws allow Wakefern to assess its patrons for net losses suffered by the cooperative (Article XIX).

(4) Wakefern is not taxed like an ordinary corporation under Federal tax law. A cooperative is permitted to determine its taxable income by reducing its gross income by amounts paid as patronage dividends (IRC § 1382[b][1]). Dividends paid by an ordinary corporation are paid out of its earnings and profits and do not reduce the corporation's taxable income (IRC § 316[a]). The Division points out that, for Federal tax purposes, Wakefern and petitioner treated the Wakefern distributions as patronage dividends and not as ordinary dividends. Wakefern deducted the patronage dividends from gross income when determining Federal taxable income. Petitioner did not exclude any portion of the patronage dividends from

taxation for either Federal or State purposes.[4]

To support its characterization of the patronage dividends as rebates, the Division cites to Federal cases where similar payments were deemed to be rebates or refunds (see, People's Gin Co. v. Commr., 2 TCM 325; Uniform Printing & Supply Co. v. Commr., 88 F2d 75, 37-1 US Tax Cas ¶ 9093). Petitioner claims that these cases have no precedential value because they were decided before Subchapter T became effective. In addition, petitioner contends that the patronage dividends are dividends from investment because they represent the distribution of the earnings of the corporation. Petitioner cites to two cases to support its contentions (see, Coastal Chemical Corp. v. U.S., 401 F Supp 141, 75-2 US Tax Cas ¶ 9604; Land O' Lakes v. U.S., supra).

The history of the statutory scheme applicable to taxation of cooperative income and patronage dividends was described by the Court of Appeals for the Eighth Circuit in Farm Service Cooperative v. Commr. (619 F2d 718). Since the Court's analysis addresses many issues raised here, it will be quoted in full.

> "A. The Statutory Scheme: Taxation of Cooperative Income and Patronage Dividends.
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> "By virtue of consistent administrative practice, all cooperatives have been permitted to treat patronage payments as a deduction from gross income (under specified conditions) since 1914. T.D. 1996, 16 Treas. Dec. Int. Rev. 100 (1914); Logan, Federal Income Taxation of Farmers' and Other Cooperatives, 44 Tex. L. Rev. 250, 285-86 (1965). The theory underlying this tax treatment is clear, although stated in various ways: the cooperative is merely an agent for the patron; a patronage dividend constitutes a rebate or price adjustment for the patron; or the money returned in fact always belonged to the patron. See, Des [Moines] County Farm Service Co. v. United States, 324 F. Supp. 1216, 1219 (S.D. Ia.). aff'd per curiam, 448 F.2d 776 (8th Cir. 1971).
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> "The deductibility of patronage dividends first received explicit legislative

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[4]Under IRC § 243(a)(1), a corporation is entitled to a special deduction from gross income for dividends received from a domestic corporation that is subject to income tax. A corporation may exclude 70% of dividends received from corporations owned less than 20% by the recipient corporation. Tax Law § 208.9(a)(2) provides that "entire net income" of a taxpayer corporation shall not include 50% of dividends other than from subsidiaries.

recognition and approval in the Revenue Act of 1951, ch. 521, § 314(a)(2), 65 Stat. 492 (repealed 1962). See, Des Moines County Farm Service Co. v. United States, supra, 324 F. Supp. at 1219. It was generally thought at that time that the earnings of cooperatives would be currently taxable either to the cooperative or to its patrons. Subsequent court decisions, however, held that noncash allocations of patronage dividends, though deductible by the cooperative, were not taxable to the patron.

"The enactment of subchapter T, section 17(a) of the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, was intended to overturn these decisions. S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted in [1962] U.S. Code Cong. & Ad, News 3304, 3414. Subchapter T, I.R.C. §§ 1381-888 permits cooperatives to deduct amounts allocated in cash or scrip as patronage dividends, and it makes patrons currently taxable on these patronage dividends to the extent that they arise out of the patrons' business transactions with the cooperative. 'Exempt' cooperatives, those satisfying the criteria of I.R.C. § 521(b), may allocate to their patrons and deduct not only earnings derived from patronage activities, but also dividends on capital stock and earnings derived from business done for the United States or from nonpatronage sources. I.R.C. § 1382(c). See generally Land O'Lakes, Inc. v. United States, 514 F. 2d 134 (8th Cir.), cert. denied, 423 U.S. 926 (1975); Logan, Federal Income Taxation of Farmers' and Other Cooperatives, 44 Tex. L. Rev. 250 (1965). Nonexempt cooperatives may allocate and deduct only income arising from business done with patrons and then only under additional conditions specified in I.R.C. § 1388(a).

"Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

"Because of this restriction on the scope of allowable deductions, nonexempt cooperatives must separate patronage - from nonpatronage-sourced income. A nonexempt cooperative is a hybrid business organization, taxed like an ordinary corporation with respect to a nonpatronage-sourced income (see subchapter C, I.R.C. § 301 et seq.), but like a partnership with respect to patronage-sourced income. See Conway County Farmers Ass'n v. United States, 588 F. 2d 592, 596 (8th Cir. 1978). That is to say, nonpatronage-sourced income is fully taxable to the cooperative and, if paid out in dividends to the patron, to him as well. Patronage-sourced income is taxed only once, usually to the patron." (Emphasis added.)

It is clear from this passage that a patronage dividend is an amount paid to the patron as a result of business transacted between the cooperative and the patron. As such, it is properly treated as business income under Article 9-A of the Tax Law. Petitioner's arguments to the contrary are rejected.

Petitioner's position rests primarily on its contention that the patronage dividends it received represent a distribution of the gross earnings of Wakefern and, as such, qualify as

investment income from petitioner's investment in the stock of Wakefern. Petitioner notes that the gross earnings of a cooperative are "determined without any adjustment . . . by reason of any allocation or distribution to a patron out of the net earnings" (IRC § 1382[a]). In short, gross earnings includes patronage dividends.[5] Petitioner argues that a distribution of corporate gross earnings to a shareholder is income from investment in the corporation (i.e., investment capital) and hence investment income. This argument does

not reflect the substance of the actual transactions that occurred. Wakefern did not distribute its gross earnings to its shareholders based on the amount of each shareholder's investment. It distributed the net earnings of each of its product departments to Wakefern patrons based on the volume of business done by the patron with that department. Moreover, petitioner's argument is in conflict with the statutory definition of a patronage dividend and judicial decisions which hold that a patronage dividend is, by its nature, a payment which is not based on capital invested in a corporation but on business transacted with that corporation.

The Internal Revenue Code states that "the term 'patronage dividend' means an amount paid to a patron by [a cooperative] organization" (IRC § 1388[a]). A patronage dividend does not mean an amount paid to a shareholder, and payments to shareholders are patronage dividends only if those shareholders are also patrons (see, Mississippi Valley Portland Cement Co. v. U.S., supra). A patronage dividend is based on "the quantity or value of business done with or for such patron" (IRC § 1388[a][1]). By definition then, the Wakefern patronage payments were based on petitioner's business transactions with Wakefern and not on its investment in Wakefern. Wakefern's obligation to pay petitioner (arising out of its By-Laws) "existed before [petitioner] received the amount so paid" (IRC § 1388[a][2]). As the Division notes, because ordinary dividend income is paid out of the "earnings and profits" of a

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[5]Petitioner cites to a number of cases and administrative decisions which make the same point, that patronage dividends are includible in the gross earnings of a cooperative (see, Coastal Chemical Co. v. U.S., supra; Rev Rul 66-53, 1963-1 CB 206). This principle is not in contention and needs no further discussion.

corporation (IRC § 316[a]), there can be no pre-existing obligation to pay an ordinary dividend. This aspect of a patronage dividend has been found to be significant in distinguishing patronage dividends from ordinary dividends (see, People's Gin Co. v. Commr., 118 F2d 72, 41-1 US Tax Cas ¶ 9318). Finally, the amount of the Wakefern payments was not determined based on the overall earnings of Wakefern but "from business done with or for [Wakefern] patrons" (IRC § 1388[a][3]). Since Wakefern was legally obligated to pay the patronage dividends, those amounts were never includible in Wakefern's earnings and profits (i.e., its after tax profits) and were not dividends for purposes of IRC § 316(a). As petitioner states, "[t]he critical issue is whether the Wakefern earnings distributions result from Big V's investment in Wakefern's stock" (Petitioner's Reply Brief, p.11). By virtue of qualifying as patronage dividends under section 1388 of the Internal Revenue Code, the distributions were based on the quantity of business done by petitioner with Wakefern. As such, they do not constitute investment income.

B. Every taxpayer allocates its business income within and without New York State on the basis of a three-factor formula which generally takes into account the taxpayer's real and tangible personal property, receipts and payroll (Tax Law § 210.3; 20 NYCRR 4-2.2). As petitioner readily concedes, there is no provision in the Tax Law which would permit it to include the property, receipts and payroll of Wakefern in the computation of its business allocation percentage. It requests permission to do so under the authority of Tax Law § 210.8 which grants the Commissioner of Taxation and Finance the discretion to vary the statutory formula if it does not properly reflect the activity, business, income or capital of a taxpayer in New York.

Section 4-6.1(c) of the Commissioner's regulations prohibits a taxpayer from varying the statutory business allocation percentage formula without prior consent of the Division. Taxpayers are directed to attach such a request to their corporation franchise tax reports, setting forth all the information on which the request is based, together with a computation of the amount of tax which would be due under the proposed method (20 NYCRR 4-6.1[c]).

The Division argues that petitioner's request is untimely since petitioner did not seek prior

consent to vary the business allocation formula. It also contends that the information provided by petitioner is incomplete in that it does not include a computation of the amount of tax which would be due under the alternative method and does not include sufficient information to enable the Division to make such a calculation. Finally, the Division takes the position that petitioner has not shown that the statutory formula fails to properly reflect its business activity and income in New York.

I agree with petitioner that failure to seek prior permission to vary the statutory formula should not bar it from requesting such relief in the course of an audit. In Matter of Autotote Ltd. (Tax Appeals Tribunal, April 12, 1990), the Division conducted an audit of the petitioner where certain facts were established that indicated that petitioner should be permitted to file on a combined basis under the Division's own regulations. The Division refused petitioner's request for permission to combine on the sole ground that the request was not made within 30 days of the end of the fiscal years in question as required by 20 NYCRR 6-2.4(a). The Tribunal held that where the Division had the opportunity to examine and scrutinize petitioner's business activities during an audit it could not rely on the 30-day requirement as its sole reason for denying combination. The facts in this case are sufficiently similar to those in Autotote to require a similar result. The audit established that petitioner had classified 100% of its patronage dividends as investment income in 1987, 50% in 1988 and 80% in 1989. The Division classified all amounts received as patronage dividends as business income. Petitioner asked that all patronage dividends be classified as investment income, but as an alternative requested that the business allocation formula be varied to include a portion of Wakefern's real and tangible personal property, receipts and payroll. At this point, any information needed by the Division to make a decision would have been available on audit; moreover, petitioner had no reason to request a variation of the business allocation percentage until the Division reclassified the patronage dividends. Under these circumstances, petitioner's failure to seek prior permission to vary the formula cannot be the sole rationale for denying its request.

The Division's complaint that petitioner has yet to provide the information necessary to

recalculate the business allocation formula is also not a reason to deny petitioner permission to vary the formula. Paragraph 21 of the Stipulation states:

> "Although both parties anticipate a reduction would result [from recalculation of the formula], no calculation has been performed at the time of this stipulation agreement. Such calculation will be performed on remand of this matter to the Division of Taxation (if so ordered by the Division of Tax Appeals)."

Thus, it appears that the Division has acquiesced to a procedure which allows petitioner to provide pertinent information after a final decision is rendered by an Administrative Law Judge or the Tax Appeals Tribunal.

With these issues resolved, I will now address the more substantive issues. I will first summarize petitioner's arguments for allowing it to include a proportional share of Wakefern's real and tangible personal property, receipts and payroll in its business allocation percentage. Petitioner begins by noting that it has a very substantial investment in the stock of Wakefern and that the patronage dividends represent a substantial portion of petitioner's entire net earnings. Petitioner also points out that if it undertook to perform for itself the activities now performed by Wakefern (wholesaling inventory), it would be required to directly own warehouses and employ personnel and it would have earnings from those operations. Since petitioner obtains the wholesale function by participating in the Wakefern wholesale cooperative, it argues that it should be permitted to reflect Wakefern's wholesale function in its own business allocation ratios. Petitioner likens the relationship it has with the Wakefern cooperative to a partnership relationship in that the income of Wakefern flows through to its patron shareholders. Petitioner claims that an adjustment to the statutory formula is necessary to reflect this relationship accurately.

After consideration of petitioner's argument and the legal authority cited by it, I conclude that petitioner has not established that the statutory formula fails to result in a fair allocation of its business income in and out of New York; therefore, the factor relief it seeks is denied.

The sum and substance of petitioner's argument is that classifying the patronage dividends as business income unfairly severs the income from the assets that produced it. Petitioner cites to Alpha Portland Cement Co. v. Knapp (230 NY 48, cert denied 256 US 702)

in support of its position. I reject petitioner's underlying premise that the patronage dividends are a product of its investment in Wakefern stock; therefore, I conclude that application of the statutory formula does not sever income from the asset that produced it.

The income in question, the patronage dividends, was not distributed to the shareholders based upon their proportional share of capital invested in Wakefern. The difference between prices charged to stockholder patrons on their inventory orders and the discounted prices paid by Wakefern on volume purchases creates the earnings of Wakefern. These earnings were distributed to the patrons based upon the dollar volume of business done with each product department. As the Division has stated, the substance of the transaction was a volume discount on purchases. That the discounts were accumulated and paid at the end of each year rather than being paid as purchases were made is irrelevant. The distribution of Wakefern's volume purchase discount resulted in a reduction of petitioner's cost of goods sold and a consequent increase in its earnings. The earnings, in the form of patronage dividends, were properly classified as New York business income.

The earnings from Wakefern to petitioner bear such a direct relationship to petitioner's volume of purchases that they cannot be viewed as a simple pass through of income to the shareholders. Earnings were distributed based on the earnings of each Wakefern product department in proportion to the volume of business done by a patron with that department. Losses in any one department were distributed to patrons in proportion to the volume of business done with that department, unless otherwise determined by the Wakefern board of directors. The evidence in the record does not establish that there was a direct correlation between stock ownership requirements and volume of business done with each department. The amount of stock ownership required was determined by the board of directors and set forth in an investment policy. Generally, the stock investment was based on each store's weekly purchases from Wakefern, not on purchases from each product department. Theoretically then, two patrons with identical investments in Wakefern could have different earnings because of the relative profitability of one department over another.

Petitioner has a sizeable investment in the stock of Wakefern. Through its ownership of Wakefern stock, it has an interest in the business assets of Wakefern. But the patronage dividends are not a product of petitioner's interest in Wakefern's assets. Petitioner states that if it had "invested directly in its own wholesale function, that function would be represented in Big V's business allocation ratios". Presumably, petitioner would have to purchase its own warehouses, hire employees and acquire other assets if it was to perform the function now performed for it by Wakefern. However, any discussion of what effect this would have on petitioner's allocation percentages would be purely speculative.

Finally, I do not agree with petitioner that a cooperative corporation is similar enough to a partnership or a subchapter S corporation to warrant similar treatment for purposes of determining petitioner's business allocation percentages (see, 20 NYCRR 4-6.5). A nonexempt cooperative corporation, like Wakefern, is allowed a deduction from gross earnings for patronage dividends, but it is allowed no deduction for distributions paid to patrons to the extent that such payments are from earnings other than business done with or for patrons (Farm Service Cooperative v. Commr., supra). Consequently, nonexempt cooperatives, like Wakefern, must separate patronage from nonpatronage-sourced income. It is then taxed like an ordinary corporation with respect to nonpatronage-sourced income, and like a partnership with respect to patronage-sourced income, and to that extent may be described as a "hybrid business corporation" (id., at 723). But a cooperative corporation does not share all of the characteristics of a partnership or subchapter S corporation.

New York follows the Federal provisions relating to taxation of partnerships and their partners (IRC §§ 701-705) and of S corporations and their shareholders (IRC, subchapter S). Partnerships as an entity are not subject to the personal income tax; however, each partner is taxed in his or her individual capacity as a partner (Tax Law § 617[a]). Likewise, S corporations are not subject to the corporation franchise tax, providing that every shareholder elects to be taxed under the New York personal income tax laws (Tax Law § 208.9). New York has adopted the conduit rule of the Federal provisions and, as a result, items of partnership and

S corporation income, gain, loss or deduction retain their character as they pass to the partners or S corporation shareholders (Tax Law § 617[b]). This taxing scheme is very different from the taxing scheme of cooperatives and their patrons. Most importantly, a cooperative organization's items of income, gain, loss or deduction are not passed through directly to the patron shareholders.

C. Tax Law § 208.9(a)(2) allows an exclusion of 50% of dividends from entire net income, other than from subsidiaries. Petitioner argues that, regardless of the outcome of the other issues raised here, the patronage dividends qualify for this exclusion. I disagree and conclude that it would be totally inconsistent with the prior analysis regarding the nature of patronage dividends to allow such an exclusion.

The term "dividend" is not defined by the Tax Law or regulations promulgated under the authority of the Tax Law. New York's courts have established a general rule that whenever practicable and reasonable the Federal construction of similar tax provisions should be adopted in construing State tax provisions (see, Matter of Marx v. Bragalini, 6 NY2d 322, 333, 189 NYS2d 846, 854). Accordingly, the relevant Federal law and regulations regarding the definition of a dividend will be applied here. The term "dividend" is defined in section 316(a) of the Internal Revenue Code as "any distribution of property made by a corporation to its shareholders" out of accumulated or current earnings and profits. To be considered a dividend, a distribution of earnings must be made by a corporation to its shareholders in their capacity as shareholders (Treas Reg § 1.301-1[c]). A patronage dividend is understood by the Federal courts to be "a rebate or price adjustment" (Farm Service Cooperative v. Commr., supra). Moreover, to qualify as a patronage dividend a payment must "arise out of the patrons' business transactions with the cooperative" (id.). Therefore, a patronage dividend is not paid to shareholders in their capacity as shareholders. Petitioner concedes in the Stipulation (¶ 5) that patronage dividends do not qualify for the Federal dividend exclusion (IRC § 243). It has offered no persuasive reason why New York State should follow a different practice. Since patronage dividends are not deemed dividends under Federal law, they cannot be "deemed"

dividends under Tax Law § 208.9(a)(2).

D. The petition of Big V Supermarkets, Inc. is denied, and the notices of deficiency dated September 13, 1991 are sustained.

DATED: Troy, New York
March 16, 1995

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE