STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MCDONNELL DOUGLAS CORPORATION	:	AMENDED DETERMINATION DTA NO. 813275
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1977 and 1980 through 1985.	:	

Petitioner, McDonnell Douglas Corporation, P.O. Box 516, Mail Code 100-2190, St. Louis, Missouri 63166-0516, 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 1977 and 1980 through 1985.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on November 2, 1995 at 9:30 A.M., with all briefs to be submitted by March 14, 1996. Petitioner appearing by Reid & Priest, LLP (Diana A. Steele, Esq., and Laurie S. Marsh, Esq., of counsel) submitted a brief on December 22, 1995. The Division of Taxation appearing by Steven U. Teitelbaum, Esq. (James P. Connolly, Esq., of counsel), submitted a brief on February 6, 1996. Petitioner's reply brief was submitted on March 14, 1996, which date commenced the six month period for issuance of this determination (Tax Law § 2010[3]).

ISSUES

I. Whether, upon reporting to New York certain final federal audit adjustments to income, petitioner also properly adjusted the receipts factor of its business allocation percentages (and, as a consequence, adjusted its business allocation percentages) for the years involved based on suchchanges to income and was not precluded from making such adjustments by virtue of Tax Law § 1083(c)(7).

II. Whether the Division of Taxation's interpretation and application of Tax Law § 1083(c)(7) so as to preclude adjustment of petitioner's business allocation percentages is violative of the Due Process and/or Commerce Clauses of the United States Constitution.

III. Whether, assuming that the receipts factor of the business allocation percentages may be adjusted in light of the Federal audit changes to income, petitioner has established that its recalculated receipts factors properly attributed all of the Federal audit changes to activities/sources outside of New York (i.e., that all of the dollar changes were includable in the denominator of the receipts factor with no part of such changes sourced to New York and included in the numerator of such factor).

FINDINGS OF FACT[1]

1. On April 26, 1993, the Division of Taxation ("Division") issued to petitioner, McDonnell Douglas Corporation, two notices of deficiency assessing additional tax, in the aggregate, of $177.00 for the taxable years 1977 and 1980 through 1982, and $207,416.00 for the taxable years 1983 through 1985, plus interest (these notices are sometimes referred to collectively as "the 1993 notices"). Penalties were not assessed on these notices and are not an issue in this proceeding.

2. Petitioner is a Maryland corporation with its corporate headquarters and principal place of business in St. Louis, Missouri. Petitioner is authorized to conduct business in New York State and/or conducts business in New York State. Petitioner is primarily engaged in the manufacture and sale of commercial and military aircraft throughout the United States. Petitioner also engages in related business activities, including the sale of spare aircraft parts, the sale of information systems, and the sale of information system services. Petitioner's business is carried out through eight to ten different operating divisions. Some of petitioner's divisions have sales based on long-term contracts, while others do not. The majority of petitioner's business in New York State consists of sales of parts and services, rather than long-term contracts for the manufacture and sale of aircraft. Petitioner's operating divisions which

[1]The parties stipulated to certain facts in this matter. Said stipulated facts are included in the Findings of Fact herein.

are involved in long-term contract work are located in California (Long Beach and Huntington Beach), Florida (Titusville), Missouri (St. Louis), and Oklahoma (Tulsa).

3. Petitioner files New York State franchise tax reports in which it allocates its business income between New York and other jurisdictions in which it is authorized to do business and/or does business based upon its business allocation percentage ("BAP") calculated pursuant to Tax Law § 210(3).

4. The BAP is a percentage based upon a weighted average of three factors: a receipts factor (the "Receipts Factor"), a property factor, and a payroll factor. The Receipts Factor is equal to a fraction, the numerator of which is the taxpayer's total receipts, including sales, sourced in New York ("New York Receipts"), and the denominator of which is the taxpayer's total receipts, including sales, everywhere ("Total Receipts").

5. Prior to 1977, petitioner reported its long-term aircraft manufacturing contracts for Federal income tax purposes pursuant to either the percentage of completion method of accounting or pursuant to a specific delivery method. In 1977, petitioner requested and received permission from the Internal Revenue Service (the "IRS") to report all of its long-term contracts pursuant to the "completed contract" method of accounting.

6. In its New York State franchise tax reports for the taxable years 1977, 1978 and 1979 as originally filed, petitioner calculated the Receipts Factor using sales other than as reflected on its Federal corporate income tax returns for such taxable years ("Book Sales"). Petitioner's New York Receipts, Total Receipts and Receipts Factor for the taxable years 1977 through 1979, as originally reported, were as follows:

YEAR	N.Y.RECEIPTS	TOTAL RECEIPTS	RECEIPTS FACTOR
1977	$11,269,865.00	$3,597,273,804.00	.3133%
1978	$ 9,394,838.00	$4,154,256,849.00	.2262%
1979	$14,995,379.00	$5,226,531,926.00	.2869%

7. In 1980, the Division conducted a field audit of petitioner's 1977 through 1979 franchise tax reports. By a letter dated January 27, 1981, the Division proposed adjustments to such reports, specifically with regard to the calculation of petitioner's BAP on such reports. The Division's proposed adjustments changed the calculation of the Receipts Factor by replacing

Book Sales with the amount of sales reported by petitioner on its Federal corporate income tax returns ("Federal Sales"). The adjusted Total Receipts and adjusted Receipts Factor proposed in the January 27, 1981 letter were as follows:

YEAR	N.Y. RECEIPTS	ADJ. TOTAL RECEIPTS	ADJ. RECEIPTS FACTOR
1977	$11,269,865.00	$1,896,362,802.00	.5943%
1978	$ 9,394,838.00	$4,573,797,687.00	.2054%
1979	$14,995,379.00	$5,617,594,248.00	.2669%

8. The Division did not make any changes to the New York Receipts portion (the numerator) of petitioner's Receipts Factor for the years 1977 through 1979, noting in its field audit report that petitioner's receipts sourced to New York consisted mainly of receipts from sales of spare parts and information systems as opposed to long-term manufacturing contracts, and thus were not affected by the change to a completed contract method of accounting.

9. By notices of deficiency dated May 15, 1981, the Division asserted deficiencies against petitioner for its 1977 and 1979 taxable years based upon the above-described adjustments ("the 1981 notices"). Petitioner challenged the 1981 notices by filing a petition with the Tax Appeals Bureau of the former State Tax Commission. Following a prehearing conference, which resulted in no adjustments to the 1981 notices, petitioner decided to withdraw its petition and consent to a discontinuance of its protest to the 1981 notices.

10. The Division conducted an audit of petitioner's franchise tax reports for the taxable years 1980 through 1982 ("the 1980 - 1982 Audit"). In this audit, the Division required that petitioner use the completed contract method of accounting in calculating its Receipts Factor, and adjusted petitioner's Total Receipts to reflect Federal sales for such years. No change was made to petitioner's New York Receipts, however, since such receipts were mainly from sales of parts and services rather than long-term contracts. Since the 1980 - 1982 Audit, petitioner has calculated its Receipts Factor based upon Federal sales as required by the Division.

11. Petitioner timely filed New York State franchise tax reports for the taxable years 1980 through 1985. Such reports, as initially filed for the taxable years 1980 through 1982, based the calculation of the Receipts Factor on petitioner's Book Sales. However, after the 1981

petition was withdrawn, a correction was made to reflect calculation of the Receipts Factor based on sales as reported for Federal income tax purposes. With regard to the balance of such reports (i.e., pertaining to the taxable years 1983 through 1985), petitioner calculated the Receipts Factor based upon its sales as reported for Federal income tax purposes, that is in a manner consistent with petitioner's withdrawal of its petition against the 1981 notices. The New York Receipts, Total Receipts and Receipts Factor reflected in petitioner's franchise tax reports for the years 1980 through 1985 as originally filed were as follows:

YEAR	N.Y. RECEIPTS	TOTAL RECEIPTS	RECEIPTS FACTOR
1980	$ 15,389,196.00	$5,922,339,699.00	.2598%
1981	$ 14,485,318.00	$7,075,046,520.00	.2047%
1982	$ 16,835,195.00	$5,608,499,623.00	.3002%
1983	$ 48,506,801.00	$8,365,850,763.00	.5798%
1984	$227,469,846.00	$4,045,212,887.00	5.6232%
1985	$ 61,999,226.00	$7,498,816,822.00	.8268%

12. The 1980 through 1982 New York Receipts, Total Receipts and Receipts Factors, after the correction to sales per federal income tax returns versus sales per books, were as follows:

YEAR	N.Y. RECEIPTS	TOTAL RECEIPTS	RECEIPTS FACTOR
1980	$15,389,196.00	$3,811,150,752.00	.4038%
1981	$14,485,318.00	$5,738,293,477.00	.2524%
1982	$16,835,195.00	$5,599,000,224.00	.3007%

13. During 1987, petitioner was subjected to a Federal audit of its 1977 through 1985 Federal income tax returns. As described hereinafter, the IRS proposed numerous changes to petitioner's income for such years, the most significant of which involved the timing of income recognition under the completed contract method of accounting. In general, under petitioner's interpretation of such method of accounting, a contract would be held open and income thereunder would not be recognized until all of the specifications under the contract had been met. In contrast, the IRS proposed, and petitioner ultimately agreed, that income under such contracts should be recognized when the final primary subject matter of the contract had been fulfilled (for example upon delivery of the final aircraft ordered under the contract) rather than as of the date when all final contract specifications were met. As a consequence, income

recognition for Federal income tax purposes was accelerated on many of petitioner's long-term contracts. Examples of the types of and/or reasons for the IRS adjustments included: determinations that a long-term contract was completed when the firm number of aircraft ordered per contract were delivered as opposed to when any option for additional aircraft was fulfilled; splitting long-term manufacturing contracts into manufacturing parts and service parts; and converting (reclassifying) long-term manufacturing contracts into service contracts (in such latter instances causing such contracts to be accounted for, in part or in whole, under accrual accounting as opposed to completed contract accounting).

14. In 1987, revenue agent's reports ("RAR's") were issued by the Internal Revenue Service ("IRS") with respect to petitioner's taxable years 1977 through 1980 ("the First RAR's"). These RAR's proposed adjustments to petitioner's total sales as reported on its Federal corporate income tax returns for the years 1977 through 1980 ("the Federal Adjustments"). The proposed adjustments involved primarily the acceleration of sales income under petitioner's long-term manufacturing contracts.

15. On June 4, 1987, petitioner filed summary schedules representing amended franchise tax reports for the years 1977 through 1980 ("the 1977 - 1980 Amended Reports"). These reports were filed, as required under Tax Law § 211(3), to report the changes in income resulting from the Federal Adjustments for the years 1977 through 1980. On its 1977 - 1980 Amended Reports, petitioner conceded the accuracy of the Federal Adjustments with respect to such years and included the adjustments in its calculation of entire net income for such years.

16. In the 1977 - 1980 Amended Reports, petitioner also adjusted the denominator of its Receipts Factor to reflect the changes made by the Federal Adjustments. For one of the years involved, 1980, such adjustments were an increase to Total Receipts by the amount of the Federal Adjustments for such year. Petitioner did not change its New York Receipts (i.e., the numerator of the Receipts Factor) for any of such years.

17. For the 1980 taxable year, petitioner reported the adjustments to Total Receipts to reflect the Federal Adjustments, and as a consequence recalculated its Receipts Factor as follows:

YEAR	NY RCPTS	ADJS TO TOTAL RCPTS	ADJ TOTAL RCPTS	ADJ RCPTS FACTOR
1980	$15,389,196.00	$1,485,761,106.00	$5,296,911,858.00	.2905%

18. Assuming petitioner is entitled to change its BAP, the "Adjustments to Total Receipts" and the "Adjusted Total Receipts" shown above are accurate reflections of the Federal Adjustments. However, the Division does not concede or agree that petitioner properly sourced all of such adjustments outside of New York State, and thus does not concede or agree to the accuracy of the "New York Receipts" or the "Adjusted Receipts Factor" as set forth above.

19. On November 27, 1991, RAR's were issued by the IRS with respect to the taxable years 1981 through 1985 ("the Second RAR's"). These RAR's proposed adjustments to petitioners total sales as reported on its Federal corporate income tax returns for the period 1981 through 1985 ("the Additional Federal Adjustments"). Again, the changes proposed by the Additional Federal Adjustments were primarily the acceleration of sales income under petitioner's long-term manufacturing contracts.

20. On February 25, 1992, petitioner filed summary schedules representing amended franchise tax reports for the years 1977 through 1985 ("the 1977 - 1985 Amended Reports"). The 1977 - 1985 Amended Reports were filed as required under Tax Law § 211(3), to report the changes in income resulting from the Additional Federal Adjustments. In the 1977 - 1985 Amended Reports, petitioner conceded the accuracy of the Additional Federal Adjustments with respect to taxable years 1981 through 1985 and included such adjustments in its calculation of entire net income for such years.

21. In the 1977 - 1985 Amended Reports, petitioner adjusted the denominator of its Receipts Factor to reflect the changes made by the Additional Federal Adjustments. For two of such years, 1982 and 1985, such adjustments were an increase to Total Receipts by the amount of the Federal Adjustments for each year. Petitioner did not change its New York Receipts (i.e., the numerator of the Receipts Factor) for any of such years. Petitioner reported the adjustments

to Total Receipts to reflect the Additional Federal Adjustments and, as a consequence, recalculated its Receipts Factor as follows:

YEAR	N.Y. RCPTS	ADJS TO TOTAL RCPTS	ADJ TOTAL RCPTS	ADJ RCPTS FACTOR
1981	$ 14,485,318	($ 872,326,692.00)	$ 4,865,966,785	.2977%
1982	$ 16,835,195	$ 521,756,599.00	$ 6,120,756,823	.2751%
1983	$ 48,506,801	($1,359,961,725.00)	$ 7,764,781,250	.6247%
1984	$227,469,846	($ 191,809,209.00)	$ 3,853,403,678	5.9031%
1985	$ 61,999,226	$3,042,347,676.00	$10,541,164,498	.5882%

22. Assuming petitioner is entitled to change its BAP, the "Adjustments to Total Income" and "Total Receipts" amounts above are accurate reflections of the Additional Federal Adjustments. For the years 1982 and 1985, the Division does not concede or agree to the accuracy of petitioner's sourcing the Additional Federal Adjustments outside of New York State, and therefore does not concede or agree to the accuracy of the "New York Receipts" or the "Adjusted Receipts Factor" shown above. However, for the years 1981, 1983 and 1984, the Division does not dispute the accuracy of petitioner's sourcing the Additional Federal Adjustments outside of New York State or the Adjusted Receipts Factors resulting therefrom.

23. In 1992, the Division performed a desk audit of the 1977 - 1980 Amended Reports and the 1977 - 1985 Amended Reports ("the 1992 Audit"). During the 1992 Audit, the Division made a number of adjustments to petitioner's amended reports. One of the Division's adjustments was to disallow petitioner's changes to Total Receipts made, as described above, following the Federal Adjustments and Additional Federal Adjustments. As a result, the Division effectively disallowed petitioner's changes to its Receipts Factor which, in turn, disallowed the resultant changes to petitioner's BAP. In sum, the Division changed the BAP on petitioner's 1977 - 1985 Amended Reports to reflect the BAP reported by petitioner on its corporation franchise tax reports as originally filed or as determined by or following the 1980 Audit.

24. On September 14, 1992, the Division issued a Notice of Assessment Resolution with respect to the 1992 Audit ("the Notice of Assessment Resolution"). The Notice of Assessment Resolution set forth the adjustments described above and provided, in explanation

of the Division's disallowance of the petitioner's Receipts Factor changes which resulted in the described changes to petitioner's BAP, as follows:

> "Sec. 1083(c)(7), of the New York Tax Law, prohibits a change in the allocation percentage once the three year statute has expired. Please refer to [TSB-H-82(6)C]."

25. On April 26, 1993, the Division issued the 1993 Notices of Deficiency. For the taxable year 1977, the 1993 notices of deficiency calculated petitioner's BAP using petitioner's Receipts Factor as adjusted by the Division pursuant to the 1981 notices of deficiency, while for the taxable years 1980 through 1985, the 1993 notices of deficiency calculated petitioner's BAP using petitioner's Receipts Factor as reported in petitioner's originally filed or corrected franchise tax reports. In sum, the 1993 notices of deficiency incorporated the disallowance of the adjustments to petitioner's BAP as proposed in the Notice of Assessment Resolution, and provided in explanation thereof the following:

> "No change in the allocation is allowed after the 3 year statute has expired. The business allocation percentage allowed reflects prior audit findings; or as originally filed."

26. The primary factual issue dealt with at hearing was the question of whether all of the income adjustments resulting from the Federal audit were properly treated as involving non-New York source income. On this issue, petitioner provided the testimony of one Robert K. Evans. Mr. Evans, who currently serves as petitioner's tax manager, has been employed in petitioner's tax department from June 1981 through the present, and over such time period has been promoted from assistant audit tax accountant through a number of different employment titles each with an increased sphere of responsibility to his present title. Mr. Evans testified that the Federal adjustments related primarily to petitioner's long-term contract sales, and that since petitioner's sales in New York were not the result of long-term contracts but rather consisted of sales of aircraft spare parts and computer systems and related services the same would have been accounted for on an accrual basis as opposed to the completed contract method of accounting and would not have been affected by the RAR's. Mr. Evans further testified that the Federal adjustments resulted mainly from the acceleration of closing dates for long-term

contracts, both in the sense of earlier-than-reported closing of the contracts or of severance of a contract into manufacturing and services segments. Specifically, Mr. Evans stated that all of the significant Federal changes ". . . were associated with our long-term contracts, the completion applicable to our commercial aircraft deliveries and had to do with military missile contracts, all of which were long-term contracts". Mr. Evans noted that with respect to adjustments related to other types of income, the same was not New York source income because either the subject matter of the contract was not delivered to New York or that the services under the contract were not performed in New York. Mr. Evans displayed through his testimony a strong familiarity with petitioner's various operating divisions and the subject matter and location of the endeavors in which each was involved. Finally, he noted that the divisions involved with the contracts which were the subject of the RAR's had never reported any New York sales, and that while not every RAR and underlying contract with which the RAR dealt was offered in evidence by petitioner, the same would be prohibitively voluminous to offer into evidence. On this score, petitioner noted that the Federal audit was a comprehensive audit covering all of the members of petitioner's consolidated group of corporations. However, petitioner did provide at hearing all of the RAR's that resulted in a Federal adjustment which impacted petitioner's Receipts Factor. There is no evidence that the Division was precluded from conducting a field audit with regard to the documents underlying the Federal changes or that the Division requested but was refused access to any of such documentary information. Finally, petitioner noted that in its earlier audits, the Division accepted and made no changes to petitioner's New York Receipts as reported (i.e., when changing Total Receipts from book to Federal income tax amounts the numerator of the Receipts Factor was not changed), pointing to the statement in the Division's prior audit report that petitioner's New York Receipts were from sales of parts and services rather than long-term contracts.

27. Petitioner has submitted proposed findings of fact numbered "1" through "47". Each of such proposed facts has been accepted and incorporated herein, except for proposed facts numbered "27" and "34" to which the Division has raised an objection. The Division's

objection is that, contrary to such proposed facts, petitioner has not established that all of the changes made by the RAR's involved income which was properly sourced outside of New York State (i.e., that all of the income adjusted on Federal audit was non-New York source income). In that the propriety of sourcing all of the Federal changes outside of New York is an issue presented for ultimate resolution herein, proposed facts "27" and "34" are rejected insofar as they reach the ultimate conclusion that petitioner's sourcing was proper.

28. Petitioner and the Division have agreed that in light of the small dollar amount involved ($177.00 plus interest) the 1993 notices with respect to the 1977 taxable year will not be contested.

CONCLUSIONS OF LAW

A. By way of introductory general background, there is no dispute that petitioner, a foreign corporation doing business in New York, was subject to New York's Corporation Franchise Tax during the years in issue computed upon its entire net income base. In turn, petitioner's entire net income base means the portion of its entire net income (i.e., its Federal taxable income with certain statutorily required modifications) allocable to New York. The amount of petitioner's entire net income allocable to New York is determined by multiplying petitioner's business income by its business allocation percentage ("BAP").

B. Petitioner's BAP is determined based on three factors, to wit, property, receipts, and payroll. More specifically, the BAP represents the arithmetic average of the ratios of a corporate taxpayer's property, receipts and payroll values within New York State to those of such corporate taxpayer as a whole. In arriving at such arithmetic average, the receipts ratio is counted twice (i.e., double weighted). Tax Law § 210(3)(a)[2] provides for calculating the three factors (property, receipts, and payroll) comprising the BAP as follows:

> "(1) ascertaining the percentage which the average value of the taxpayer's real and tangible personal property . . . within the state during the period covered by the report bears to the average value of all the taxpayer's real and tangible personal property . . . wherever situated during the period . . . ,

[2]Since the Tax Law sections cited herein have remained substantially the same as the law in effect during the applicable period, I have cited to the current law.

"(2) ascertaining the percentage which the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its entire net income, arising during such period from

(A) sales of its tangible personal property where shipments are made to points within this state,
(B) services performed within the state . . . ,
(C) rentals from property situated, and royalties from the use of patents or copyrights, within the state, . . . and
(D) all other business receipts earned within the state . . .
bears to the taxpayer's receipts, similarly computed, arising during such period from all sales of tangible personal property, services, rentals, royalties, . . . whether within or without the state . . .;

"(3) ascertaining the percentage of the total wages, salaries and other personal service compensation, similarly computed, during such period of employees within the state, . . . to the total wages, salaries and other personal service compensation, similarly computed, during such period of all the taxpayer's employees within and without the state . . . ,

C. Petitioner, an entity doing business in New York, was required to file annual franchise tax reports, and to compute its BAP and, ultimately, its tax liability on its allocated entire net income, as above (Tax Law § 211). In addition, Tax Law § 211(3) requires taxpayers such as petitioner to report any federal audit changes or corrections in income to the Division within 90 days after the final (Federal) determination of such changes or corrections, as follows:

"If the amount of taxable income or alternative minimum taxable income, for any year of the taxpayer . . . , as returned to the United States treasury department is changed or corrected by the commissioner of internal revenue or other officer of the United States or other competent authority, . . . such taxpayer shall report such changed or corrected taxable income or alternative minimum taxable income . . . within ninety days after the final determination of such change or correction . . . , and shall concede the accuracy of such determination or state wherein it is erroneous."

D. The foregoing requirement to report Federal changes or corrections under Tax Law § 211(3) leads to an exception to the general three year statute of limitations on assessment imposed by Tax Law § 1083(a). Specifically, Tax Law § 1083(c)(3) provides (notwithstanding closure of the general three year limitation period on assessments) that an assessment may be made within two years after a report or amended return of Federal changes is filed. Such an exception exists of necessity since Federal changes or corrections may not be finalized before the general three-year statute of limitations has passed, and thus the Division would be

otherwise precluded from the ability to audit Federal change reports and assess tax if necessary. However, Tax Law § 1083(c)(7) goes on to provide that:

> "[n]o change of the allocation of income or capital upon which the taxpayer's return (or any additional assessment) was based shall be made where an assessment of tax is made during the additional period of limitation under [Tax Law § 1083(c)(3)] . . . ."

It is this last provision which is at the heart of the dispute in this case.

E. The accuracy of the Federal changes to petitioner's income has been conceded and is not at issue, nor is there any question that petitioner timely reported such changes to New York as required by Tax Law § 211(3). Remaining in question, however, is the extent, if any, to which such changes to income may impact the percentage amount of petitioner's entire net income ultimately allocated and subjected to tax by New York. Resolution of this remaining question turns on two determinations. First, the essential question is whether petitioner must allocate its entire net income to New York, as finally changed or corrected per Federal audit, based on its BAP as existing prior to such Federal changes. Stated differently, the initial issue is whether petitioner, who is required to report the Federal changes to its receipts, is precluded from taking those changes into account in the calculation of the receipts factor of its BAP by which such changed receipts will be allocated and subjected to tax by New York. In turn, and assuming petitioner is entitled or required to reflect such Federal changes in the calculation of its receipts factor, the issue devolves to whether petitioner has established that the changed receipts were all non-New York source receipts and were properly excluded from the numerator of the receipts factor. It is worth observing that the concerns of this case are not present at the Federal level, since the allocation of income to its jurisdictional sources becomes relevant only with regard to taxation of a multistate entity's income by and among the various states in which such an entity does business.

F. Petitioner focuses on the specific language of Tax Law § 210(3)(a) and 20 NYCRR 4-4.1 which states that the BAP component ratios must be computed based on the items, including specifically, income "arising during the period covered by the report". Petitioner maintains that such language mandates inclusion of the Federal changes in the BAP calculation

notwithstanding Tax Law § 1083(c)(7) - - that is, all receipts arising during the report period which are covered by the report and are included in the computation of entire net income for the report period, must also be taken into account in calculating a taxpayer's BAP. Simply put, Tax Law § 210(3)(a) requires the inclusion of all property, receipts and payroll owned, earned or paid during the specific reporting period. Petitioner asserts that to include the Federal income changes in entire net income as required, but not to adjust the receipts factor and, in turn, the BAP by which such changed income is to be allocated to New York and subjected to tax, results in taxing corrected income based on an uncorrected BAP and thereby subjecting such changed income to tax without regard to the source thereof as required. Petitioner points out that the Federal adjustments at issue here caused income originally recognized in a given year to be moved to and recognized as arising in a different year. In turn, petitioner maintains that Tax Law § 210(3)(a) requires it to adjust its Receipts Factor and its BAP in light thereof to include such income in the (changed) year of recognition. Petitioner goes on to maintain that under the Division's interpretation, there exists a substantial risk of multiple taxation, whereby non-New York source income taxed by the jurisdiction in which it was earned would also be subject to tax by New York because the BAP was not adjusted in light of the changed receipts. Petitioner contends such a result violates Commerce Clause and Due Process Clause standards. Petitioner argues that to adopt the Division's position serves to change what should be an income recognition timing change into an absolute tax liability dollar difference. Petitioner contends that such a result is neither fair, especially in light of the fact that a taxpayer cannot always know within the general three year period of limitations that its income may be changed as the result of a Federal audit, nor consistent with the nature of the change resulting from such a Federal audit.[3]

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[3]Petitioner notes that the Division doesn't challenge the non-New York sourcing of the income changes for the "decrease years" - - 1981, 1983 and 1984 (see Finding of Fact "23"). Since such sourcing decreases the Receipts Factor denominator but does not change the numerator, the result is a higher receipts allocation ratio. Thus, it is not entirely surprising that the Division would not specifically object to such sourcing, but rather would simply maintain the consistent assertion that adjustments to income allocation are not permissible per Tax Law § 1083(c)(7).

In contrast, the Division argues that the plain language of Tax Law § 1083(c)(7) does not allow any changes to the BAP as originally reported or as changed on audit. The Division maintains that in the case of a Federal change or correction, the statute of limitations is opened by the required reporting of such Federal change or correction, and remains open for a period of two years thereafter during which the Division may make an assessment if necessary based on such Federal changes. However, the Division argues that the statute of limitations remains closed with regard to making any change to the allocation basis (i.e., the BAP) as originally reported or changed on audit. The Division contends that the main policy consideration behind not allowing changes to the BAP is sound, specifically in that it allows for "repose" through closure such that reported results will not be subject to change many years down the road from the year in question. This policy, the Division argues, avoids the disadvantage to a taxpayer of being put to the test of providing evidence sufficient to meet the burden of proving the propriety of its allocation or sourcing of the items of Federal change at a point so late in time that documentary substantiation and/or necessary witnesses with sufficient knowledge may no longer be in existence or available. The Division maintains that its position avoids audit and proof difficulties, and also tempers the fiscal impact of federal changes by preventing the application of a revised BAP against already reported income.

G. Petitioner's argument that the Division's interpretation of Tax Law § 1083(c)(7) violates Due Process and Commerce Clause standards under the United States Constitution is rejected. Petitioner's claim in this regard is that by being precluded from adjusting its Receipts Factor and its BAP from that originally reported (or adjusted on audit), results in income from non-New York sources potentially being subjected to New York tax. Petitioner argues that failing to adjust for changed income can result in an inaccurate portrayal of petitioner's New York income and an inherent substantial risk of multi-jurisdictional taxation of the same income.

H. Both parties agree that in order for a state to tax the income of a nondomiciliary corporation arising out of extraterritorial activities, without running afoul of Due Process or

Commerce Clause standards, there must be a "minimal connection" or "nexus" between the outside activities and the taxing state and a "rational relationship between the income attributed to the State and the intrastate values of the enterprise" (British Land (Maryland), Inc. v. Tax Appeals Tribunal, 85 NY2d 139, 623 NYS2d 772, citing Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 63 L Ed 2d 510). States have broad discretion in devising and applying formulae for income apportionment. Such formula methods of apportionment will generally be upheld as applied to arrive at a State's taxable portion of an entity's entire interstate income where such entity engages in business in the State, subject however to the "correlative limiting principle" that "[a] State may not by formula apportionment tax income 'which cannot in fairness be attributed to the taxpayer's activities within the State'" (citations omitted) (British Land (Maryland), Inc. v. Tax Appeals Tribunal, supra at 146) Thus, as in British Land, "a formula based tax on income may be struck down if the income attributed to the State is in fact out of all appropriate proportion to the business transacted [by the taxpayer] in the State . . . or if application of the apportionment formula has led to a grossly distorted result." (Id.)

In simple terms, apportionment formulas such as that employed in this instance represent attempts to estimate the economic activity of an entity in a particular jurisdiction. Here, the petitioner has not shown that the interpretation urged by the Division results in attribution of income which is "out of all appropriate proportion" or which leads to "a grossly distorted result". Thus, petitioner has not shown that the Division's position will result in taxing of income violative of Commerce Clause or Due Process standards. (see, Matter of Allied Signal, Inc., v. Tax Appeals Tribunal, ___ AD2d ___, ___ NYS2d ___, [July 18, 1996]).

I. Turning to the issue of whether petitioner is statutorily precluded from adjusting its BAP to reflect the Federal changes, a seeming conundrum is presented. That is, Tax Law § 210(3)(a) specifically requires the Receipts Factor of the BAP to be based on receipts for the period covered by the report, whereas Tax Law § 1083(c)(7) precludes any change to the BAP where an assessment is made during the two year open period following the required reporting of Federal changes. This problem of apparently conflicting statutory sections may be

reconciled, however, by recognizing that the prohibition of Tax Law § 1083(c)(7) appears to preclude the Division from making an income reallocation (i.e., changing the BAP) as part of any audit and assessment activities occurring during the two year period after such a Federal change report has been filed by a taxpayer. That is, since the Division is the assessing party, it would be the Division which would be precluded under section 1083(c)(7) from changing the BAP when an assessment is made. However, the plain words of such section do not preclude a taxpayer from adjusting its receipts factor to reflect therein the sources of the changes to receipts arising during the period covered by the report, as required by Tax Law § 211(3). In turn, there is no apparent preclusion against the Division thereafter challenging such a recalculation by the taxpayer versus the originally reported or later audit adjusted BAP. Simply put, while the Division (the assessing party) can't of its own initiative reallocate income by changing the sources of receipts or other BAP factors upon an audit of taxpayer-reported Federal changes, the Division is (fairly enough) not bound to accept any such reallocation reported by a taxpayer with its report of Federal changes. Accordingly, a Division assessment (post-Federal changes) will not be based on a Division initiated change of allocation of income from that originally reported or changed on audit and will therefore not contravene Tax Law § 1083(c)(7), while the Division will at the same time not be precluded from challenging taxpayer initiated allocation adjustments.

It is recognized, as the Division points out, that such a result can lead to burden of proof difficulties. However, the same are inevitable, given the delay or passage of time before Federal changes are finalized and must be reported. Petitioner in result will be required to establish the propriety of the sourcing of the changed receipts, with the failure to do so leaving such receipts to be allocated based on the BAP as originally reported or as changed on (prior) audit. Such issues notwithstanding, petitioner's interpretation is ultimately the resolution most consistent with the words of the sections of law involved. Accepting the Division's interpretation prohibits petitioner from complying with the statutory requirement of including or taking into account all of the income which arose during a given year in computing its receipts

factor and its BAP. Under the Division's interpretation and result, petitioner's Receipts Factor is simply not based, as required, on all of the receipts which arose during the year covered by the report.

In addition to the foregoing, petitioner's position appeals to consistency. That is, the Federal adjustments to income as reported by petitioner are consistent with the adjustments resulting from prior Division audits (that receipts should be reported as per Federal tax returns under the completed contract method of accounting rather than as per books [see Finding of Fact "6"], and the sourcing of the adjusted income is consistent with comments from such prior years' audits (that petitioner's New York receipts consisted mainly of receipts from sales of spare parts and information systems as opposed to long-term manufacturing contracts and thus were not affected by the change to the completed contract method of accounting [see Findings of Fact "8" and "10"]). It is important to remember that the Federal changes centered on the timing of when petitioner had to recognize income from its long-term contracts for planes and missiles. In light of the nature of the Federal changes, the amount of entire net income available for allocation to and taxation by New York in any given year is changed from the amount originally reported by the taxpayer or adjusted per (State) audit. Such change, of necessity, means the changed income items were not, and could not, have been included and taken into account in the determination of the Receipts Factor (or the BAP) as originally computed or as recomputed per (State) audit for such years. Thus, it follows that the sources of such income should be taken into consideration when determining the basis by which such income is to be allocated to New York. In addition, the Division's main argument against reflecting such changed income items in the Receipts Factor as well as, ultimately, in the BAP, is the policy of finality - - that the parties can rest assured that results from many years prior will not be disturbed, and that taxpayers will not be at the disadvantage of being unable to establish the propriety of where to source federally changed income many years down the road when witnesses and/or substantiating documents may well be unavailable. While the policy of finality is generally laudable (see e.g., Matter of Turbodyne, Tax Appeals Tribunal, July 3, 1996), it must be

balanced in consideration of consistency and fairness under the circumstances of Federal changes (cf., American Can Company v. State Tax Commn., 13 AD2d 175, 215 NYS2d 109; appeal dismissed, 10 NY2d 1015, 224 NYS2d 689). Specifically, pure adherence to the desire for finality overlooks the fact that changes to income in fact have a direct impact on the calculation of the formula by which such (changed) income will be allocated and taxed. Moreover, the party allegedly most disadvantaged (in light of bearing the burden of proving the propriety of its income sourcing) if the Federal changes were to be used in recalculating the Receipts Factor and the BAP is the party arguing for the right to do so, to wit, the taxpayer.

Finally, it is not disputed that the Division's interpretation results in making an income recognition timing change into a tax dollar liability difference. If Federal adjustments based on the timing of income recognition are included in the calculation of the BAP, petitioner argues there should be little or no resulting difference in tax liability over all of the years involved. In contrast, the Division's method results in tax dollar liability changes which could go in favor of either party without compensating makeup adjustments in the other years involved. To treat petitioner's adjustment as a prohibited change would essentially ignore section 210(3)(a) and its requirement that a taxpayer's BAP be based on all receipts which arose during the period covered by the report. Petitioner, therefore, correctly reflected the Federal changes to receipts in its BAP by "flowing through" such to changes to the calculation of its BAP per Tax Law § 210(3)(a) Thus, the BAP "change" urged by petitioner is more aptly considered a required adjustment under the statute than a prohibited change per Tax Law § 1083(c)(7).

J. There remains, finally, the issue of the propriety of petitioner's sourcing of the Federal changes out of New York (i.e., the "burden of proof" issue as to whether all of the Federal changes dealt with non-New York source income). The Division's challenge on this issue is based on the fact that not every RAR from the entire Federal audit was offered in evidence and upon the view that petitioner's witness testified in a simple and conclusory manner lacking sufficient depth of particular knowledge to carry petitioners' burden of proof. Viewed as a whole, however, the evidence supports petitioner's claim that the changed income was non-New

York source income. On this score, petitioner provided a witness who testified with some specificity about the setup and operation of petitioner via its various divisions, and who reviewed and discussed the RAR's causing the changes to petitioner's receipts. While admittedly not submitting every Federal audit RAR, petitioner did provide all of such RAR's impacting its Receipts Factor. In turn, petitioner's witness explained the reasons for the Federal changes relevant to this case, noting that the significant changes all related to adjustments of the timing of recognition of income on various contracts (see, Findings of Fact "14", "20" and "26"), including specifically long-term contracts for the manufacture of aircraft and missiles.[4] Petitioner's witness had knowledge of the types of sales which would be sourced to New York, and explained that none of petitioner's long-term contracts would be so sourced, a point consistent with the findings of prior audits of petitioner as conducted by the Division. Finally, although other items of adjustment were made pursuant to the federal audit, petitioner's witness explained that the same were in comparison de minimis and, in any event, were items at all times accounted for under accrual accounting (as opposed to completed contract accounting), such that the same would have no impact for purposes of this case. Accordingly, the Division's argument that petitioner did not meet its burden of establishing the propriety of sourcing all of the Federal audit adjustments outside of New York is rejected.

K. The petition of McDonnell Douglas Corporation is hereby granted to the extent that the notices of deficiency dated April 26, 1993 are to be revised and reduced in accordance with this determination and, as so revised and reduced, are sustained (excepting only the notice pertaining to 1977 which by agreement of the parties was not contested and is thus sustained as issued).

DATED: Troy, New York
October 3, 1996

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[4]With regard to the 1977 - 1980 Amended Reports, petitioner reported changes to the Property Factor (its New York property and its property everywhere) as well as to its Receipts Factor (specifically its receipts everywhere). With regard to the 1977 - 1985 Amended Reports, the only reported changes were to petitioner's Receipts Factor (specifically its receipts everywhere). While the Division noted that petitioner offered no evidence vis-a-vis the property changes, it does not appear that such changes were directly at issue in this proceeding or that petitioner was on notice of any need to defend or discuss the impact thereof.

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE