STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
TROPICANA PRODUCTS SALES, INC.	:	DETERMINATION DTA NOS. 815253
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended July 31, 1989 through July 31, 1993.	:	AND 815564

Petitioner, Tropicana Products Sales, Inc., 1001 13th Avenue East, Bradenton, Florida 34208-0338, 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 fiscal years ended July 31, 1989 through July 31, 1993.

A hearing was held before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 22, 1997 at 9:15 A.M., was continued on October 23, 1997 at 9:15 A.M. and was concluded on November 14, 1997 at 9:15 A.M., with all briefs to be submitted by May 26, 1998, which date began the six-month period for the issuance of this determination. Petitioner appeared by Horwood, Marcus & Berk, Esqs. (Fred O. Marcus, Esq., of counsel) and by Morrison & Foerster, LLP (Hollis L. Hyans, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (James P. Connolly, Esq., and Kenneth J. Schultz, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined that petitioner, Tropicana Products Sales, Inc., was required to file a combined franchise tax report which included Progress Services, Inc. to avoid distortion of petitioner's New York activities, business, income or capital.

II. Whether petitioner may file a separate franchise tax report on the ground that a combined report with its parent corporation, Tropicana Products, Inc., was not required in order to avoid distortion of petitioner's New York activities, business, income or capital.

III. Whether the Division, by requiring petitioner to file a combined New York State franchise tax report which includes Tropicana Products, Inc. and Progress Services, Inc., violates the Due Process Clause and the Commerce Clause of the United States Constitution.

FINDINGS OF FACT

On October 22, 1997, the parties, by their representatives, entered into a written stipulation of facts (consisting of 56 numbered paragraphs along with attached exhibits), the contents of which have been substantially incorporated into the following Findings of Fact. In addition, on January 30, 1998, petitioner submitted, along with its brief, 60 proposed findings of fact, each of which has been substantially incorporated into the following Findings of Fact, except:

(a) the first sentence of proposed finding of fact "3", the second sentence of proposed finding of fact "30" and the phrase "as is customary in the industry" in proposed finding of fact "33" are rejected as not being supported by the record;

(b) the third sentence of proposed finding of fact "31", the last sentence of proposed finding of fact "50" and proposed finding of fact "60" are rejected as being conclusory in nature; and

(c) proposed finding of fact "29" relates to a period several years subsequent to the audit period and is, therefore, irrelevant.

On March 25, 1998, the Division of Taxation submitted, along with its brief, 90 proposed findings of fact, each of which has ben substantially incorporated into the following Findings of Fact, except:

(a) proposed findings of fact "9", "11" and "12" relate to procedural matters not in dispute and are, therefore, irrelevant;

(b) the first sentence and the phrase "because if a [sic] orange processor is big enough, a peels operation becomes economically viable" in proposed finding of fact "41", the phrase "he was struck by the imbalance between the results of TPS and PSI" in proposed finding of fact "46", the phrase "although not especially with the 1994 regulations" in proposed finding of fact "55", all but the first sentence of proposed finding of fact "58" and proposed findings of fact "60" and "64" are rejected as being conclusory in nature;

(c) proposed finding of fact "38", the second sentence of proposed finding of fact "66", the last sentence of proposed finding of fact "69", proposed finding of fact "82" and the first sentence of proposed finding of fact "83" are rejected as not being supported by the record; and

(d) the following proposed findings of fact, while essentially correct, contained numerical errors which have been corrected: "1981" in proposed finding of fact "34" was corrected to properly read "1980"; "$18,500" in proposed finding of fact "35' was corrected to properly read $18,750"; various percentages in the table contained in proposed finding of fact "47" were in error and were, therefore, corrected; and ".1%" in proposed finding of fact "48" was corrected to properly read ".9%".

1.. Tropicana Products, Inc. ("TPI") is a Delaware corporation with its principal offices in Bradenton, Florida.

2. The petitioner herein, Tropicana Products Sales, Inc. ("TPS"), also a Delaware corporation, is a wholly-owned subsidiary of TPI. Its principal offices are located at TPI's Bradenton, Florida facility.

3. Progress Services, Inc. ("PSI"), a Florida corporation, is a wholly-owned subsidiary of TPI. Its principal offices and production facilities are located at TPI's Bradenton, Florida facility.

4. For the years at issue,[1] TPI, TPS, PSI and the other members of the TPI federal affiliated group filed a consolidated Federal income tax return. During the years at issue, TPS filed combined New York returns that included the income and factors of TPI and certain of its subsidiaries ("TPS/TPI group"), but excluded the income and factors of PSI.

5. Pursuant to an examination of the books and records of TPS for the fiscal years ended July 31, 1989 through July 31, 1991, the Division of Taxation ("Division") issued a Notice of Deficiency dated April 11, 1994 to petitioner in the amount of $368,674.00, plus penalty and interest, for a total amount due of $495,294.49 for these years. The Division determined that PSI was engaged in a single unitary business with the TPS/TPI group and that in order to properly reflect the income of TPS, the income and factors of PSI had to be combined with the income and factors of the TPS/TPI group. The Division does not contend that TPI or PSI were required to file New York separate franchise tax returns for the years at issue.

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[1]While the petition in this proceeding indicated that the periods at issue were fiscal years ended July 31, 1989 through July 31, 1993, petitioner, at the hearing, withdrew its claims for refund for fiscal years ended July 31, 1992 and July 31, 1993, as audits for these periods had not yet been conducted. Accordingly, the periods at issue are fiscal years ended July 31, 1989 through July 31, 1991, only.

6. On or about April 30, 1996, petitioner filed amended New York general business corporation franchise tax returns (forms CT-3) and amended metropolitan transportation business tax surcharge returns (forms CT-3M/4M) for the fiscal years ended July 31, 1989 through July 31, 1991 and requested a refund of the taxes paid for those years. The theory upon which petitioner filed the amended returns was its contention that TPS and TPI should be allowed to file on a separate basis on the ground that a combined return with TPI was not required in order to avoid distortion of the New York activities, business, income or capital of TPS. The Division neither allowed nor denied TPS's refund claims.

7. On or about December 16, 1996, or more than six months after the date on which TPS filed the amended returns, TPS filed a petition with the Division of Tax Appeals seeking the amounts asserted to be due to TPS per its amended returns (this petition was in addition to the petition filed on or about July 30, 1996 contesting the amounts asserted to be due from TPS in the Notice of Deficiency).

In this matter, the Division waived reliance on the 30-day rule (20 NYCRR 6-2.4) as a basis for denial of the refunds requested in the amended returns. In exchange, TPS agreed that the Division would be allowed to conduct a field audit to determine whether TPI and TPS should be filing on a combined basis. On October 20, 1997, the Division issued a letter affirming the deemed denial of TPS's refund claims.

8. For purposes of this proceeding, TPS does not, for the years at issue, contest that it, TPI and PSI constitute a unitary business involving the production and sale of juice, juice-based beverages and cattle feed made from orange by-products.

9. For purposes of this proceeding, TPS does not, for the years at issue, contest that it had "substantial intercorporate transactions" with TPI within the meaning of 20 NYCRR 6-2.3(b) nor

does TPI contest that it had "substantial intercorporate transactions" with PSI within the meaning of 20 NYCRR 6-2.3(b).

TPI's BUSINESS

10. TPI is engaged in the production, distribution and sale of not-from-concentrate chilled orange juice, grapefruit juice and apple juice, juices made from concentrate and a variety of other unchilled blended fruit juice beverages (they shall be collectively referred to as the "juice product"). TPI is the world's leading producer of chilled orange juice and holds a dominant share of the chilled orange juice market in the northeastern United States. All of TPI's juice product for domestic consumption is sold to TPS. TPI makes all foreign sales of its juice product through Seagram Export Foreign Sales Corporation Limited, a foreign corporation within the meaning of section 922 of the Internal Revenue Code.

11. TPI owns and maintains its headquarters and primary production facility in Bradenton, Florida and also owns and operates a second production facility at Ft. Pierce, Florida.

12. TPI is the largest processor of Florida oranges. Oranges are the largest single raw material purchased by TPI. Approximately 95 percent of the oranges purchased by TPI are purchased from Florida growers under contracts which range in length from one to twenty years.

13. TPI processes whole oranges and grapefruits into not-from-concentrate chilled juices at each of its Bradenton and Ft. Pierce facilities. Juice processed at the Bradenton facility is also packaged there. Juice processed at the Ft. Pierce facility is shipped in bulk to the Bradenton facility for packaging. Juice processed at the Bradenton facility for shipment to TPS's City of Industry, California facility is packaged by TPI in barrels, in concentrate form, at the Bradenton facility. TPI's processing facilities are located close to the source of its raw materials supply because such a location minimizes transportation costs and eliminates potential spoilage.

14. TPI also engages in product research and development. TPI's research and development activities include formulating new products, participating in product design and identifying customer needs. TPS assists in formulating new products by providing input regarding product design and customer needs. TPI incurs all the expenses and bears all the risks associated with its product development, process development and other research and development activities.

15. TPI owns the "Tropicana" brand name and other product brand names. The "Tropicana" brand name is considered to be one of the most powerful brand names in the food and beverage industry. The book value of this and the other intangible assets owned by TPI was approximately $412,000,000.00 in fiscal year 1991.

16. TPI provides a number of services centrally to TPS and PSI, including pension administration, payroll, centralized accounting, tax return preparation, information systems and other corporate programs.

17. TPI bears virtually all of the risks arising in connection with its juice production business. TPI bears the market risks for sales of its juice products. TPI is solely responsible for in-store loss or product spoilage.

TPS's BUSINESS

18. TPS is primarily engaged in the wholesale sale and distribution of juice product manufactured by TPI in Bradenton, Florida. During the years at issue, there was no written contract in relation to the sale and transfer of juice product between TPI and TPS and there were no invoices prepared. TPS provides at least three distinct services for TPI: sales and distribution, transportation and marketing.

19. TPS sells its product directly and indirectly to five types of customers located throughout the United States and Canada: large grocery chains, food service, convenience stores, mass merchandisers and the military.

TPS sells juice products to large retail grocers on a nationwide basis; these sales to large grocery chains account for approximately two-thirds of TPS sales. TPS ships product directly to these grocery chain customers who generally maintain their own refrigerated warehouses and distribute the product to their own store locations. For retail grocers who do not have their own warehouse facilities, TPS either distributes the juice products to wholesalers or the juice products are picked up by the wholesalers at TPS's distribution facility in Jersey City. These sales are supported by TPS with brand and trade marketing such as newspaper coupons, grocery store ads, special display cases and television air time.

TPS's food service customers include schools, hospitals and restaurants. Sales to these customers are generally made through large independent wholesalers. As with its grocery customers, TPS either distributes its products directly to food service operators or indirectly through wholesalers. For food service operator customers in the New York City metropolitan area, TPS provides a direct store delivery option from its Whitestone, New York distribution facility.

TPS sells to convenience stores through smaller local distributors, brokers or routemen in the densely populated northeastern United States. In the New York City metropolitan area, TPS sells directly to independent routemen who distribute products daily to smaller customers using their own refrigerated trucks.

20. TPS also sells juice products to mass merchandisers like Sam's, Wal-Mart and BJ's.

Although mass merchandisers are the largest single type of purchaser of juice products from TPS by volume, sales to such customers do not account for the largest percentage of TPS's sales. TPS distributes its products to mass merchandisers either directly or indirectly through wholesalers.

21. Sales to military bases and installations account for the remainder of TPS's sales of juice products. It distributes its products to the military directly or indirectly through wholesalers.

22. In addition to its principal location in Bradenton, Florida and its City of Industry, California plant, TPS also maintained regional offices in Braintree, Massachusetts; New York, New York; Chicago, Illinois; Ft. Lauderdale, Florida and Los Angeles, California. It also operated a distribution facility in Kearney, New Jersey until the summer of 1990; it opened a distribution facility in Jersey City, New Jersey during the summer of 1990.

23. TPS employed approximately 55 employees at its Bradenton, Florida offices. These employees were engaged in sales, management and support activities and included managers, analysts, coordinators and clerical staff.

Until it ceased operations, the Kearney, New Jersey distribution facility employed approximately 100 people. They included order takers, dispatchers, logistical personnel and product handlers. The Kearney distribution facility serviced the northeastern United States, including New York. When it commenced operations, the Jersey City facility employed a similar number of individuals in similar positions.

TPS employed an additional 60 to 70 individuals in the New York City metropolitan area. These individuals were primarily engaged in direct sales. Terrence S. Schulke, TPS's vice president for sales employed at the Whitestone, New York facility, stated that he was aware of

the fact that certain managers, originally employed by TPI, had been transferred to the employ of TPS.

24. Product sold to customers located in the northeastern United States, including New York (more than a third of TPS's U.S. sales are in the northeast, with most of those sales to the metropolitan New York area), was shipped by TPS via rail from Bradenton, Florida to New Jersey in its unit train, i.e., specialized refrigerated rail cars owned and operated by TPS. This mode of transportation produces large cost savings. Product from TPI's Florida facilities sold to customers in the remainder of the United States is shipped form Bradenton, Florida via rail or common carrier. TPS performs much of the direct shipment of products to wholesalers for which purpose it owns a fleet of trucks. TPS bears the costs associated with the transportation of juice products from Bradenton to customer locations.

25. After arrival at TPS's Jersey City distribution facility, packages of Tropicana juice products are unloaded and stored for sale to large distributors and major consumers. Some of the juice product is transported by tractor trailer to TPS's other distribution facility in Whitestone, New York for ultimate sale in the New York City metropolitan area.

26. TPS performs both brand and trade marketing. Brand marketing consists of general advertising related to the promotion of the Tropicana name such as national television ads, event sponsorships (such as the Tropicana Bowl) and manufacturer's coupons. Trade marketing activities include funding special retail displays, grocery store advertisements and product placement (such as on store shelves and in aisle displays). TPS incurs all expenses arising in connection with its brand and trade marketing activities. Other marketing expenditures incurred by TPS include hiring advertising agencies, media production costs, syndicated market research, specific retail store couponing and air time for ads.

27. TPS does not perform any research and development; all such activities are performed and funded by TPI in Bradenton. All product liability claims, credit and collection costs and interest rate risks are borne by TPI, not by TPS. Although TPS holds inventory at its Jersey City and Whitestone distribution facilities, inventory loss is guaranteed by TPI.

28. TPS does not own any of the intangible assets related to the Tropicana products it sells. The corporate brand name and other associated trade names and trade marks (Pure Premium, Twister, Grovestand, Homestyle, Season's Best, etc.) are all owned by TPI.

29. Employees of TPS handle customer complaints.

30. TPS purchased a bottling and packaging plant in City of Industry, California in January 1990. The plant performs all the packaging and bottling of Tropicana juice product sold in California and several surrounding states and also produces juice product. The plant also packages and bottles juice for third parties.

31. TPS represents that the transfer price for juice product is the price that results in TPS earning a profit equal to one percent of TPS's gross receipts from sales to third parties. Under the formula, 100 percent of TPS's costs (for transportation, sales and distribution and marketing) are reimbursed by TPI. As previously noted, there was no written contract between TPI and TPS covering the sale and transfer price of juice products during the years at issue (***see***, Finding of Fact "18"). The Division agrees that the columnar spreadsheets attached to the consolidated Federal income tax returns are consistent with this pricing methodology.

32. During the audit relating to TPS's claim for refund (based upon its contention that TPS and TPI should be permitted to file on a separate basis), in response to a question as to how TPS had developed its pricing methodology, its representative indicated that he had no knowledge of how or when the pricing formula had been developed or who had developed the

pricing formula, except that it was developed prior to 1979. The Division's auditors requested proof of arm's-length pricing such as a pricing study. In response TPS's representatives referred to a pricing study which was in the process of being prepared. On several occasions, the auditors requested a copy of this pricing study, but it was not until October 6, 1997 (approximately two weeks before the hearing held herein) that they were supplied with a copy of a report, dated October 6, 1997, prepared by Price Waterhouse LLP in support of TPS's claim that the transactions between TPS and TPI were at arm's length. A revised version of the report was introduced into evidence at the hearing by TPS. The pricing study was prepared in contemplation of litigation. Price Waterhouse LLP is the public accounting firm for TPI's parent, Joseph E. Seagram & Sons, Inc. After reviewing the pricing study, the Division, on October 20, 1997, issued a letter in which it affirmed its deemed denial of TPS's refund claims.

PSI'S BUSINESS

33. PSI was incorporated in 1980 and is engaged in the processing of waste orange peel into cattle feed and in the sale thereof. Henry Marchman, who is employed by the Tax Department of Joseph E. Seagrams and Sons, Inc. and who formerly was the Tax Manager at TPS from 1979 until 1996, stated that PSI was created to "carve out its feed operations into a more readily identified entity."

34. PSI owns a facility which houses certain production equipment which it uses to produce the cattle feed. The facility is located within TPI's Bradenton, Florida facility on real property leased from TPI and is known as the "feed mill". The feed mill owned by PSI commenced operation in 1973.

35. PSI operates exclusively in Florida. It does not sell anything to or buy anything from TPS.

36. PSI acquires the orange peels which it utilizes in its cattle feed production operation from TPI at no cost. Prior to the commencement of PSI's operation, TPI disposed of its waste orange peels, incurring a cost to do so. TPI buys oranges from a number of Florida growers, sometimes under long-term contracts. After they have been transported to the Bradenton plant, the oranges are graded and then move on a conveyor belt to the extraction room where the juice is extracted. The wet peel arrives at PSI's production facility directly from TPI on a conveyor. The manner in which the system is constructed prevents PSI from accepting peels from anyone other than TPI. Upon arrival, lime is added to the wet peel to neutralize acid contained therein and to cause the release of oils. This oil is distilled into a product called D'limonent. D'limonent is used as an industrial cleaner. Approximately ten percent of PSI's income is attributable to the sale of D'limonent.

The wet peel next enters a hammer mill where it is chopped up. Molasses is then added to cause the oil and water contained in the peel to be released. The wet peel is then pressed, dried and pelletized if for export or left in chunks if for domestic consumption.

37. PSI sells its cattle feed product to traders and agricultural brokers. During the years at issue, approximately 85 percent of PSI's product was sold for export; 15 percent was sold domestically. All of PSI's domestic customers were located in Florida. No feed was sold to customers in New York.

The price at which PSI sold its cattle feed product was determined by reference to the Amsterdam-Rotterdam futures market. The price fluctuated considerably and was largely dependent upon factors in the European market, including the number of animals, the grain situation, the corn situation and exchange rates.

38. During the years at issue, PSI produced between 135,000 and 150,000 tons of cattle feed per year. 675,000 to 750,000 tons of wet peel were required to produce these 135,000 to 150,000 tons of cattle feed. A document prepared by the former Tax Manager of TPS, Henry Marchman, set forth the exact tonnage of feed sold by PSI during the years at issue. This document which was introduced into evidence at the hearing indicates that the tax consequence which would result from requiring PSI to file a combined report would be $307,548.00 for the three years at issue. Mr. Marchman stated that dividing the entry to taxable income amount (this figure is the amount of income which has been added to the combined report as a result of the Division's proposed adjustment and was calculated to be $10,269,920.00 for the fiscal year ended July 1989, $9,624,089.00 for the fiscal year ended July 1990 and $11,274,701.00 for the fiscal year ended July 1991) by five (the number of wet tons required to yield a ton of dry feed), then dividing by the total tons of feed sold, results in a $14.00 per ton adjustment.

The market for PSI's wet peel is very limited and is restricted only to Florida. Because of the prohibitive transportation costs and the fact that the wet peel is highly perishable (it becomes rancid within 48 hours), the wet peel could not have been shipped beyond the immediate area of PSI's facility.

39. PSI directly employed the persons who were involved in the production of the cattle feed. Employees of TPI, including Penelope Durham, Manager of Citrus Commodities (during the years at issue, her title was Senior Agricultural Economist) performed a number of business functions for PSI pursuant to agreements between TPI and PSI. All nonproduction activities of PSI are performed by TPI, including freight service, payroll services, customer billing, contract negotiating and credit checking. These services were rendered pursuant to an agreement dated December 27, 1984 which required PSI to pay TPI the sum of $18,750.00 per month for these

services. In 1990 and 1991, TPI charged PSI $125,000.00 per year for the services which it performed for PSI. Ms. Durham's annual salary during these years was approximately $35,000.00. Approximately 50 percent of Ms. Durham's time was spent on selling the cattle feed on behalf of PSI. By lease agreements which were also dated December 27, 1984, PSI leased certain delivery equipment used in connection with the distribution of is feed products (the rental charges were the actual billing to the final feed customer for freight) and also leased the feed mill and feed warehouse (the rent under this agreement was $1,100.00 per month, or $13,200.00 per year).

At the hearing, no evidence was introduced as to how the prices charged by TPI under the service or lease agreements were arrived at or whether such prices charged by TPI were arm's length. Ms. Durham stated that she did not know how the charges to PSI were computed and she did not know whether such charges remained constant during the years 1989 through 1991.

40. One of PSI's major expenses in its production process was heating. A letter to the Division's representative, James P. Connolly, Esq., from one of petitioner's representatives, Fred O. Marcus, Esq., dated October 9, 1997, stated that energy costs associated with running PSI's production equipment are allocated to PSI, i.e., electricity charged is based upon the volume of production (tons of feed produced). At hearing, no evidence was presented as to how the allocation was calculated or whether the cost allocated was arm's length.

41. Juice Bowl Products, Inc. ("Juice Bowl"), an unrelated processor of citrus juice, also produced wet peel. Juice Bowl did not have a feed mill and, as a result, sold its wet peel to a third party, Sun Pac.

The price paid by Sun Pac to Juice Bowl for the wet peel was negotiated by the two parties. The average price paid by Sun Pac to Juice Bowl for the year 1990 was $5.80 per ton of

wet peel. Juice Bowl incurred a cost of $3.70 per ton for shipping the wet peel to Sun Pac's processing facility, since the agreement between the parties required Juice Bowl to bear the cost of transportation. The net price received by Juice Bowl for its wet peel was $2.10 per ton in 1990, which is calculated by subtracting the shipping costs incurred by Juice Bowl from the price per ton paid by Sun Pac for the wet peel. The price Juice Bowl received for wet peel remained relatively constant during the years at issue. Richard Miller, controller of Juice Bowl, indicated that most processors of oranges have peels operations. He stated that as Sun Pac's volume of production went up, its production costs would go down.

Mr. Miller stated that there would be certain advantages for a peels processor to be connected to an orange processing plant, as PSI is connected to TPI's plant, because it would save on handling and transportation costs. Juice Bowl's proceeds from its sale of wet peels to Sun Pac were reduced by $1.00 per wet ton due to Sun Pac's cost of handling of the peels. He indicated that, while it would be expensive to start up a peel processing plant, he felt that if Juice Bowl elected to do so, it could make a profit similar to that of Sun Pac.

42. Penelope Durham, TPI's Manager of Citrus Commodities (***see***, Finding of Fact "39") and Richard Miller, an employee of Juice Bowl, each testified that the price for peel fluctuates. Ms. Durham stated that during the years at issue, the market for wet peel was very limited and the market price was between $5.00 and $10.00 per ton of wet peel. Ms. Durham and Mr. Miller stated that, in some years, sellers of wet peel receive nothing for it. Ms. Durham acknowledged, however, that PSI has never had to destroy the peels for lack of a market. In one instance, Juice Bowl gave the owner of a cattle pasture wet peel for free in exchange for the privilege of disposing of wastewater on the owner's land.

43. At the hearing, the Division introduced the testimony of Richard Mayer, the supervising auditor for the field audit of TPS. With respect to prior audits, TPS had filed on a combined basis with TPI. Mr. Mayer stated that while performing the field audit which gave rise to the issuance of the Notice of Deficiency in this matter, no representative of TPS ever raised the issue that TPS and TPI should be filing on a separate basis.

44. With respect to the audit relating to the claims for refund, Richard Mayer, in reviewing the consolidated spreadsheets which set forth the sales figures of TPS, TPI and PSI, noted that "[w]hile TPS had 100 times the sales activity that PSI had, their bottom lines were essentially the same."

45. On the Tropicana group's consolidated Federal income tax returns (forms 1120) for the years at issue, the following information concerning TPI, TPS and PSI was set forth:

FYE 7/31/89			
	TPI	TPS	PSI
Net Sales	$767,534,942	$1,144,940,308	$20,593,713
Cost of Goods Sold	$663,231,352	$933,442,284	$6,894,475
Total of Operating Expense Deduction	$68,574,298	$197,710,033	$450,553
Taxable Income	$36,480,774	$13,506,204	$13,249,185
Ratio of Taxable Income to Net Sales	47.53%	17.96%	64.34%
Ratio of Taxable Income to Total Expenses + COGS	49.85%	119.40%	180.38%

FYE 7/31/90

	TPI	TPS	PSI
Net Sales	$837,729,849	$1,243,930,778	$14,806,238
Cost of Goods Sold	$726,411,320	$1,040,098,026	$6,611,221
Total of Operating Expense Deduction	$86,693,633	$196,634,015	$176,408
Taxable Income	$24,665,656	$7,644,663	$8,018,609
Ratio of Taxable Income to Net Sales	29.44%	61.46%	54.16%
Ratio of Taxable Income to Total Expenses + COGS	30.34%	61.81%	118.14%

FYE 7/31/91			
	TPI	TPS	PSI
Net Sales	$840,248,066	$1,218,899,222	$16,997,362
Cost of Goods Sold	$690,187,849	$977,277,260	$6,927,527
Total of Operating Expense Deduction	$106,869,880	$235,911,452	$203,157
Taxable Income	$43,884,028	$6,312,158	$9,866,713
Ratio of Taxable Income to Net Sales	52.23%	51.79%	58.05%
Ratio of Taxable Income to Total Expenses + COGS	55.06%	52.03%	138.37%

46. Of the Tropicana group's total operating expenses for the audit period, TPS incurred approximately 70% ($630 million divided by $893 million). Of the group's total taxable income for the audit period, TPS reported approximately 17% of that total ($27 million divided by $163.6 million). PSI is shown to have had .9% of the group's total operating expenses ($830,000

divided by $893 million) while it reported 19% of the group's total taxable income ($31.1 million divided by $163.6 million). TPI had approximately 29% of the group's total operating expenses for the audit period while reporting 64% of its total taxable income.

THE PRICE WATERHOUSE REPORT

47. TPS submitted into evidence a report entitled "Analysis of Intercompany Pricing Between Tropicana Products, Inc. and Tropicana Products Sales, Inc." ("the report"), prepared by the international accounting firm of Price Waterhouse LLP which was explained through the testimony of Larry L. Dildine, a partner in the firm. Mr. Dildine was retained to perform this pricing report on October 1, 1996, approximately six months after TPS filed the refund claims which are at issue in this proceeding. Mr. Dildine was qualified as an expert in economics with expertise in transfer pricing under the principles of section 482 of the Internal Revenue Code ("IRC § 482") and the regulations thereunder. Mr. Dildine had appeared as an expert witness, in regard to IRC § 482, in only a single case (on behalf of Altama Delta). This case involved the application of the 1968 regulations promulgated under IRC § 482, not the 1994 regulations at issue in this proceeding. Mr. Dildine testified that he has written articles on IRC § 482; however, his curriculum vitae did not list any of these articles and, upon cross examination, he could not recall the titles of any of the articles.

The report summarized the results of a transfer pricing study performed by Price Waterhouse under the supervision of Mr. Dildine. The purpose of the study was to analyze whether the relationships between TPS and TPI during the years at issue met the arm's-length standards of IRC § 482; the report concluded that the intercompany pricing between TPI and TPS was at arm's length.

48. The pricing formula is not fully described in the report. It states that TPS is compensated for the functions which it performs for TPI "by a markup on its costs." Upon cross examination, Mr. Dildine stated that TPS is guaranteed reimbursement for all of its expenses, plus one percent. Pursuant to the written stipulation entered into by the parties on October 22, 1997, TPS represented that the transfer price for juice product is the price that results in TPS earning a profit equal to one percent of TPS's gross receipts from sales to third parties (under the formula 100 percent of TPS's costs were reimbursed by TPI).

When this error was brought to Mr. Dildine's attention during cross examination, he contended that it was insignificant. However, his report states that: "TPI bears the market risk for its product. Through the pricing arrangement with TPS, TPI's profit varies with fluctuation in third party sales while TPS's profit is unaffected by fluctuations in sales."

49. The report indicates that, pursuant to IRC § 482, the arm's-length principle is the standard in determining appropriate transfer prices for transactions among related entities, i.e., transactions between related parties would produce the same result if they were undertaken by unrelated parties dealing at arm's length. Treas Reg § 1.482 affirms the arm's length standard and specifies various methods of analysis to determine transfer prices. Mr. Dildine stated that all of the methods are aimed at finding comparable transactions or comparable prices or results to the transactions between the related parties at issue.

The most specific method employed under the regulations is the comparable uncontrolled price method or "CUP". This method is applicable if the same goods are traded between unrelated parties under the same circumstances. If so, then the price charged in the uncontrolled transaction would govern the price charged in the controlled transaction.

A second method which requires similarity, but not exactness in the transaction, is the

comparable uncontrolled transaction or "CUT". Mr. Dildine stated that, under this method, you look at the markup on costs for a manufacturer or service provider or to the resale margin if the taxpayer is selling or reselling a product. These methods are referred to in the regulations as cost plus and resale methods. Both, however, require a comparable uncontrolled transaction.

The third method, usually applied when no clearly comparable transactions can be located, is called the comparable profits method or "CPM". Mr. Dildine stated that this method generally employs a statistical analysis to deal with variations among profit comparisons.

50. In performing his transfer analysis, Mr. Dildine first conducted a functional analysis of TPI and TPS to determine each company's functions, risks and intangible property. He visited TPI's Bradenton, Florida facilities and TPS's Whitestone, New York facility, interviewed personnel and examined public information regarding the marketplace for the products of the companies. Mr. Dildine concluded that the pricing methodology between TPI and TPS was best analyzed by evaluating TPS in comparison with other wholesale distributors of groceries and related products.

Mr. Dildine then performed an economic analysis of the transactions between TPI and TPS during the years at issue, i.e., he analyzed "the sale of finished beverage products from TPI to its related company, TPS, in which TPS has principally the functions of transportation, marketing and distribution." Mr. Dildine stated that he could find no comparable uncontrolled prices because TPI does not sell its product to any other company at the first stage for distribution in the United States market and TPS does not buy product in any significant quantity from any other supplier. Utilization of a CUP analysis was, therefore, not possible in the opinion of Mr. Dildine. When asked if he considered a CUT, Mr. Dildine replied that he looked for transactions where a company made sales of similar products under similar conditions and did find the results for two

other companies that distribute Tropicana products in a region of the country, and he used that information as part of a supplementary analysis (***see***, Finding of Fact "66").

51. Mr. Dildine categorized TPS as a company with relatively limited risks and functions that are similar to other wholesale distributors of food products so, using the CPM method, he chose to test TPS against the profitability of other companies which do similar things, but have unrelated suppliers. He acknowledged that comparability is a critical factor in performing a proper CPM analysis. Two such CPM analyses were performed.

In selecting comparables for his first CPM test, Mr. Dildine selected for comparison companies that purchased grocery products from unrelated suppliers and compete as distributors of these products. He identified such companies using Standard & Poor's Compustat PC Plus and Disclosure's Compact SEC databases. He searched those databases for companies that were considered wholesale distributors of groceries and related products under Standard Industrial Classification Code No. 514. The Standard Industrial Classification System categorizes companies based on their economic activities; the companies either classify themselves or are classified by the Securities and Exchange Commission ("SEC").

The search revealed 49 public companies which were classified on one or the other of the two databases as being primarily in the business of wholesale distribution of groceries and related products. Some of these companies were eliminated from consideration. In a few cases, it was found that a company was related to its supplier, such as being a subsidiary of a larger company, and those were eliminated. Other companies were eliminated when their business description suggested that they engaged, in a significant manner, in processing or manufacturing or developing products. Some companies were misclassified and were, therefore, eliminated. Companies that had, as a major part of their business, retail grocery sales were also eliminated.

A total of 14 companies were eventually identified as being comparables. Of the companies selected, four were located on the East coast (Atlantic Beverage Co., Inc. of Maryland; Krantor Corp. of New York; Richfood Holdings, Inc. of Virginia; and Sun City Industries of Florida).

The first test compared TPS's profitability to that of the 14 companies deemed comparable by Mr. Dildine, using return on sales ("ROS") as the profit level indicator. The ROS ratio is the ratio of operating profits to net sales (sales after returns and allowances). An ROS ratio was calculated on the sample of companies by using information provided from SEC filed reports and by applying that ratio for each one of the years at issue.

A median ROS and an interquartile range of ROS were computed. The "median" is the value of the ratio above and below which no more than 50 percent of the sample values are located. The "interquartile range" is the middle 50 percent of the ratio observations in the sample, containing the 25 percent of the observations immediately above and the 25 percent of the observations immediately below the median. Guidelines for determining the arm's length range are discussed in Treas Reg § 1.482-1(e)(2).

52. According to TPS's profit and loss statements, its average ROS over the three-year period was 0.85%. For the 14 companies deemed comparable by Mr. Dildine, the median ROS for the years at issue was 1.2% and the interquartile range was 0.7% to 1.8%. Because the ROS for TPS fell within the interquartile range for the sample companies, Mr. Dildine concluded that intercompany transactions between TPI and TPS during the years at issue were conducted at arm's length under the standards of IRC § 482.

53. The report states that "TPS is a wholesale distributor which also performs additional functions: transportation and marketing." In explaining the different approach taken in the second CPM analysis, the report states, "Again, we perform a CPM analysis, but this time, we

account for the fact that TPS performs slightly different functions from what a typical wholesale food distributor may perform. To do so, we found comparables for each of the following functions: distribution, transportation, and marketing." At the hearing, Mr. Dildine stated that "TPS has more than the usual amount of responsibility for transportation and advertising."

54. The Tropicana group's Federal returns set forth the following expenses for TPS during the years at issue:

Expenses	1989	1990	1991
Salaries and Wages	$19,423,834	$19,693,047	$ 23,038,24
Repairs	$2,151,186	$3,068,632	$ 5,409,610
Bad Debts	$44,396	$203,166	$ 543,615
Rents	$2,482,977	$4,472,607	$ 7,579,281
Advertising	$75,078,740	$67,858,735	$ 86,724,916
Employee Benefit Programs	$6,155,450	$3,323,574	$ 3,394,125
Transportation[2]	$ 52,221,342	$ 56,351,702	$ 64,546,545
Total Expense Deductions	$197,710,033	$196,634,015	$235,911,452

For each of the years at issue, TPS's transportation and marketing expenses represented more than 50 percent of its total operating expenses for the year.

55. The report states, at pages 10 and 11 thereof, the following:

> There are three unique facts which distinguish TPS from other national food distributors. First, a majority of the products distributed by TPS are not-from-concentrate fresh orange juice, which has a relatively short shelf life (63 days from production) compared to other grocery products. For this reason, there is a very high inventory turnover rate, and risk of

[2]The amount set forth for "Transportation" was taken from the "other deductions" schedule under the category of "distribution."

> spoilage and product loss. Fresh product generally must be stored in refrigerated warehouses, transported in refrigerated trucks ("reefers") or trains, and finally stored in the refrigerated section of retail supermarkets, stores, or restaurants.
>
> Second, there is a very high concentration of sales to customers in the northeastern U.S., with virtually all production taking place in Florida. While TPS distributes products to markets throughout the U.S., 35% of all U.S. sales are in the Northeast, with much of those sales to the metro New York area. The Tropicana brand is much stronger on the East coast of the U.S. than elsewhere in the country. While Tropicana has dominant market share on the East coast, it is weaker in other parts of the U.S.
>
> Third, orange juice is a relatively heavy product which is expensive to transport, but which must be processed close to the source of the oranges to insure freshness and consistency. For these reasons, TPS ships products to the Northeast by rail in the TPS-owned unit train which results in large cost savings.

56. Of the companies which the report deemed as being comparable to TPS for purposes of performing the first CPM test, some were described as performing solely distribution-type activities while others also performed marketing functions. However, one company, Nash Finch Company of Minneapolis, Minnesota is described, in part, in the report as follows: "owns and operates supermarkets, warehouse stores and combination general merchandise/food stores; grows, packs, ships and markets fresh fruits and vegetables; . . . .; owns vineyards and orchards for the production of table grapes, tree fruit, kiwi and citrus." Certified Grocers of California, Ltd. Was described in the report as operating dairy and bakery facilities and providing data processing, finance and insurance services to its patrons. Fleming Companies, Inc. operates a dairy facility and owns and operates supermarkets and a bakery. Roundy's, Inc. owns and operates retail warehouse food stores and operates a dairy and ice cream plant.

57. At hearing, when queried on why it was proper to use a company such as Vestro

Natural Foods as a comparable despite the fact that its form 10-K[3] stated that it performed baking, i.e., a manufacturing function, Mr. Dildine stated that he had investigated the data on Vestro and found that about 75 percent of its business was distribution at wholesale of natural foods and about 25 percent was baked goods, so the preponderance of its business was similar to TPS.

58. The report indicated that of the companies from the original 49 classified in SIC 514, some were eliminated because they "were in a startup situation." Mr. Dildine stated that he would reject a company which "has the characteristics of a startup, which means it has very low sales, and often would show a loss."

59. Mr. Dildine stated that a company which performed a buyout, i.e., it acquired some additional businesses would not be an appropriate comparable.

60. The report's description of the companies used as comparables does not provide any information as to how long any of these companies were in business or whether they had undergone any recent structural changes.

61. The form 10-K filed by Krantor Corporation for the year 1991 states as follows:

> Comparative results from 1990 to 1989 are not very meaningful as 1989 was not a full year of operation, and was the start up year of the Company. The 1989 loss of $297,679 ($.11 per share) is attributable to developing the Company's customer base, marketing the Company to the industry, as well as finding funding sources for the Company's activities. 1990 was an extension of that development; thus the losses continued until the Company developed its current base of accounts.

62. The form 10-K filed by Vestro Foods, Inc. indicates that it began its program of acquiring specialty food companies during 1987 as a result of an equity infusion of

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[3] A form 10-K is an annual report required to be filed with the Securities and Exchange Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934.

$5,000,000.00 by a group of institutional investors. Effective August 1, 1987, a wholly-owned subsidiary of Vestro acquired the assets of Heidi's Pastry, Inc. (this subsidiary is the foundation of the company's Fine Baked Products core). Effective January 1, 1988, Westbrae Natural Foods, Inc. merged with and into a wholly-owned subsidiary of Vestro. This subsidiary was the first in the company's Natural Foods core. Effective September 29, 1989, Vestro acquired Little Bear Organic Foods, Inc., a national marketer of organic snack foods. Effective May 1, 1990, Vestro acquired Jan Holzmeister Cheesecake, Ltd., a leading supplier of New York style cheesecake and other cakes and pies to the institutional foodservice market. The financial statements contained in the 1990 form 10-K indicate that the results for the years 1987 through 1990 were affected by these acquisitions.

The form 10-K states that operating expenses of Vestro grew by $1,829,000.00 from the prior year, primarily due to Westbrae Natural Foods, Inc. (acquired in 1988):

> where a new management team was installed after the operation was moved from Northern California to the Los Angeles area. The Company's strategy has been to invest in substantial management resources for each operating company with the capability to grow it to significantly higher levels. The Company's experience is that this investment raises expense levels in the first year after acquisition prior to commensurate increase in sales and gross profit.

63. With respect to Atlantic Beverage Company, Inc., Mr. Dildine stated that because the company had, according to its financial statement filed with the Securities and Exchange Commission, acquired some additional businesses during the year 1991, that year was not included because 1991 was not comparable to results in previous years. Despite these statements, however, the report did utilize Atlantic's ROS (return on sales) for the year 1991 in its calculations.

64. Two of the comparables, Certified Grocers of California, Ltd. and Roundy's, Inc., are

described in the report as being cooperatives which distribute food products and nonfood items to supermarkets. During cross examination, Mr. Dildine testified that he did not know whether a third comparable, United Grocers, Inc., was a co-op.

Mr. Dildine stated that a purchasing co-op "would be one that is related to its customers. It buys on their behalf." When asked if a co-op necessarily maximizes profit, he replied "[t]hat depends on what the arrangement is." He stated that he did nothing to determine whether any kind of cooperative agreement existed between the co-op and its shareholders because "we have no access to agreements between those parties. That would be confidential information."

In response to a question as to whether it would be possible for a purchasing co-op to agree to some allowances or rebates in regard to pricing, Mr. Dildine replied, "Again, there are very many different arrangements for compensation of those kinds of businesses."

The report indicates that Mr. Dildine rejected the use of a company (KFC Natl Purch Co-op), which was described in the report as "coop makes purchases of equip & food for KFC & Taco Bell." According to the report, the reason for its rejection as a comparable for purposes of the first CPM study was that it was a co-op. At he hearing, Mr. Dildine testified that this entry was in error; the reason for its rejection was because of its relationship to the supplier.

65. The report indicates that, "[t]o confirm the arm's length nature of the intercompany transactions between TPI and TPS," a second CPM test was performed, "but this time, we account for the fact that TPS performs slightly different functions from what a typical wholesale food distributor may perform." For purposes of this analysis, Mr. Dildine attempted to evaluate TPS as a service provider for each of the services which TPS provided for TPI, to wit: distribution, transportation and marketing services.

The second CPM test took TPS's costs for providing each of the three services, multiplied

by a markup which was derived from groups of what Mr. Dildine considered to be comparable businesses performing each of these services and arrived at what the report labeled as "the minimum arm's length profit that should be earned by TPS for these three services." The report refers to the product of the costs for the services times the markup as the "arm's length profit." Mr. Dildine stated that second analysis was "somewhat unorthodox."

66. As to the distribution function, the report indicates that Mr. Dildine searched for transactions between TPI or TPS and unrelated parties for use as comparables to the intercompany transactions to be analyzed. The report acknowledges that TPS does sell Tropicana product to unrelated distributors which provide similar services as those provided by TPS to TPI. Mr. Dildine was able to obtain financial information for two of these distributors. The names of these companies were provided by TPS.

The first distributor, B.K. Miller, is an unrelated company which purchases Tropicana products in large quantities, breaks down the products into smaller quantities and resells the products to wholesalers and other distributors in the Baltimore-Washington, D.C. area. B.K. Miller also sells Tropicana products to wholesalers whose sales volume is not large enough to purchase directly from TPS in the minimum quantities required. B.K. Miller's financial statements were obtained from TPS. These financial statements were provided to TPS for two of the years at issue, 1989 and 1990. Despite the fact that it was a private company and, therefore, was not required to file a report with the Securities and Exchange Commission, B.K. Miller provided the financial statements to TPS as part of its distribution relationship. No financial statements were provide to TPS for 1991. Mr. Dildine stated that he had done nothing to verify that the financial statements were, in fact, certified, audited financial statements. He also stated that his report did not utilize privately-held companies "because that information, when it can be

obtained, is unaudited information, and not generally as reliable as information from public companies for which you would have reports and financial reports. That's common practice."

The second distributor, Atlantic Beverage Company, Inc., is also an unrelated distributor which purchases product from TPS and sell to other distributors in the metro Baltimore and Washington, D.C. areas.

67. Based on data for the 1989-1990 period, Mr. Dildine computed a median markup on total costs and an interquartile range of markup on total costs for B.K. Miller and Atlantic Beverage Co., Inc. The median markup on total costs for the two companies was 5.0% and the interquartile range of markup on total costs was 3.1% to 7.0%. Mr. Dildine was unable to obtain data for 1991.

68. For the transportation portion of the second CPM test, Mr. Dildine attempted to develop a sample of independent companies in the category of freight forwarders; he searched for companies classified in SIC (Standard Industrial Classification) 4731, Transportation of Freight and Cargo, which includes agents in arranging transportation for freight and cargo. It also includes freight forwarders, which undertake the transportation of goods from the shippers to receivers for a charge covering the entire transportation, making use of the services of other transportation establishments to effect delivery. The report notes that "[t[his description matches very closely the transportation function performed by TPS." At the hearing, upon cross examination, Mr. Dildine acknowledged that a freight forwarder arranges transportation for customers, but normally does not provide the actual transportation. He further agreed that TPS did, in fact, own trucks and rail cars used to transport Tropicana product. To the question of whether TPS would be less comparable to a freight forwarder by virtue of the fact that it owned transportation assets, Mr. Dildine replied that "[t]here would be a difference." When asked what

he did to verify what transportation assets TPS has, in order to make a comparison with a freight forwarder, Mr. Dildine's response was "nothing specifically."

Using Standard & Poor's Compustat PC Plus and Disclosure's Compact SEC databases, Mr. Dildine's search produced an initial sample of 17 companies in the SIC 4731 category. He eliminated several companies from the initial sample (for the reasons that they were controlled subsidiaries, were foreign based, were in a startup situation, were engaged in significantly different lines of business or had insufficient data) and was left with a sample of ten companies. For the years at issue, Mr. Dildine then computed a median markup on total costs and an interquartile range of markup on total costs for the freight forwarders which he deemed comparable. The median markup on total costs for the ten freight forwarders was 2.6% and the interquartile range of markup on total costs was 0.3% to 5.6%.

69. For the marketing services function, Mr. Dildine searched on CD-ROM databases containing financial information and business descriptions for U.S. companies, Standard & Poor's Compustat PC Plus and Disclosure's Compact SEC. He searched for companies classified in SIC 7311, Advertising Agencies, which includes companies engaged in preparing advertising and placing such advertising in various media for clients on a fee or contract basis. An initial sample of 27 companies was found. Companies were eliminated for the same reasons as the transportation sample (***see***, Finding of Fact "68"). The remaining seven companies were deemed comparable.

For the years at issue, a median markup on total costs (8.3%) and an interquartile range of markup on total costs (7.6% to 11.2%) was computed for the advertising agencies which Mr. Dildine determined to be comparable.

70. Mr. Dildine stated that the calculations in the second CPM analysis were performed to

determine the amount it would have cost TPI to compensate unrelated companies (based on a markup of total costs) on an arm's-length basis for the distribution, transportation and marketing services which it received from TPS during the years at issue. According to Mr. Dildine's calculations, TPI would have had to pay an unrelated marketing company a least 7.6% over its costs, that number being the lower limit of the interquartile range for the sample found for advertising agencies.

The report found that TPI would have had to pay an unrelated transportation company at least 0.3% over its costs, the lower limit of the interquartile range for the sample freight forwarders.

For the distribution companies, since there were only two companies deemed comparable in his analysis, Mr. Dildine stated that he could not calculate an interquartile range; therefore, he took the average (or median) between the two companies. The median was calculated to be 5.0% over costs.

The results of Mr. Dildine's computation of markup on total costs for the companies for 1989 -1991, utilized in the second CPM analysis are set forth in the following table:

Sample	25th%	Median	75th%
Distribution - B.K. Miller & Atlantic Beverage	3.1%	5.0%	7.0%
Transportation	0.3%	2.6%	5.6%
Marketing	7.6%	8.3%	11.2%

71. The appropriate return for the various functions performed by TPS were calculated by

Mr. Dildine and are summarized in the following table:[4]

1989				1990			1991		
	Costs	Mark-up	Profit	Costs	Mark-up	Profit	Costs	Mark-up	Profit
Brand Marketing	75,079	7.6%	5,706	67,859	7.6%	5,157	86,725	7.6%	6,591
Transpor-tation	52,221	0.3%	157	56,351	0.3%	169	64,549	0.3%	194
Distribu-tion	72,838	5.0%	3,642	70,380	5.0%	3,519	80,439	5.0%	4.022
Total arm's length 9,505 Actual profit 11,360				Total arm's length 8,845 Actual profit 9,243			Total arm's length 10,807 Actual profit 9,909		
Average arm's length profit 9,719 Average actual profit 10,171									

72. In order to determine whether TPS reported a profit which was at least as high as the minimum arm's-length constructive profits of the distribution, transportation and marketing companies which he deemed to have been comparable, Mr. Dildine applied the arm's-length markup on total costs of the comparables to TPS's costs for its own distribution, transportation and marketing activities during the years at issue. As set forth in the table (***see***, Finding of Fact "71"), by applying the arm's-length markup on total costs computed for the comparable companies to TPS's actual costs, TPS's average profit for the years at issue would have been $9.7 million. The actual profit reported by TPS for this period was $10.1 million. Because TPS's actual profits exceeded the profits which it would have earned using the arm's-length markup on total costs for the sample companies, Mr. Dildine concluded that, under the second

[4]Table 3 in the report sets forth this table and notes that all figures are in $US thousands. In TPS's financial statement, found in Appendix A of the report,which Mr. Dildine testified is the source of these figures (***see***, Finding of Fact "73"), the indication is that all data is in $US millions.

CPM anlaysis, the prices between TPI and TPS during the years at issue were at arm's length and that the second analysis confirmed the results of the first CPM analysis.

73. When questioned as to the source of the cost figures for "brand marketing" and "transportation" for TPS, as set forth in Mr. Dildine's report (these figures are contained in the table in Finding of Fact "71"), he stated that they came directly from the Federal tax return of TPS. As to the "distribution" cost figure, Mr. Dildine stated that it was from a residual category, calculated by subtracting the transportation and advertising expenses from the total operating expenses in TPS's financial report. It is apparent that this method of calculating distribution costs results in such expenses noted on the Federal return as wages and salaries, depreciation and rent being treated as "distribution" costs in the second CPM test.

74. The "Executive Summary" portion of the report describes the profit level indicator used in the second CPM test as markup on total costs ("MOTC"). The table in Appendix A of the report which sets forth the financial information for the two companies used in the distribution portion of the test, i.e., B.K. Miller Co., Inc. and Atlantic Beverage Co., Inc., states that markup on total expenses was calculated as operating income divided by total expenses. In fact, the markup calculation shown in the table was computed by dividing operating income by *operating expenses*, not total expenses, meaning that the test excludes cost of goods sold.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law (more specifically, Tax Law § 209[1]) imposes a tax on foreign corporations doing business in New York State. In order to properly reflect that tax liability, Tax Law § 211(4), which gives the Division the discretion to require or permit corporations subject to New York State tax to file combined reports with certain other corporations, provides that:

> [i]n the discretion of the [Division], any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations . . . may be required or permitted to make a report on a combined basis covering any such other corporations . . . provided, further, that no combined report covering any corporation not a taxpayer shall be required unless the [Division] 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 to properly reflect the tax liability under this article* (emphasis added).

B. The Division's regulations provide that the Division may require or allow the filing of a combined report where three conditions are met: (1) a stock ownership test (20 NYCRR 6-2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3).

In the present matter, both TPS and PSI are wholly-owned subsidiaries of TPI (***see***, Findings of Fact "2" and "3"), thereby satisfying the stock ownership test. TPS does not contest that it, TPI and PSI constitute a unitary business (***see***, Finding of fact "8").

20 NYCRR 6-2.3(a), the regulation which sets forth the distortion of income test, provides as follows:

> If the capital stock and unitary business requirements described in section 6-2.2 of this part have been met, the [Division] 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.

TPS does not contest that it had substantial intercorporate transactions with TPI nor does TPI contest that it had substantial intercorporate transactions with PSI during the years at issue (***see***, Finding of Fact "9").

The presumption of distortion, as referred to in 20 NYCRR 6-2.3(a), can be rebutted by the

taxpayer by showing that the transactions between the corporations were at arm's length (***see***, ***Matter of USV Pharm. Corp.***, Tax Appeals Tribunal, July 16, 1992; ***Matter of Standard Mfg. Co.***, Tax Appeals Tribunal, February 6, 1992). In ***Matter of Standard Mfg. Co.*** (***supra***), the Tribunal determined that the applicable standard was the proper reflection of income and that where the stock ownership, unitary business and substantial intercorporate transactions tests prescribed by the Division's regulations are met, a presumption of distortion arises which the taxpayer has the opportunity to rebut by showing that filing on a combined basis is not necessary to properly reflect income in order to succeed in its assertion that filing on a separate basis is appropriate. As the Tribunal noted in ***Matter of Silver King Broadcasting of N.J., Inc***. (Tax Appeals Tribunal, May 9, 1996), where the taxpayer rebuts the presumption of distortion, the Division, in order to require combination, must show why it believes that reporting on a separate basis does not properly reflect income. It is not sufficient for the Division merely to identify possible areas of distortion; it must, at a minimum, identify with particularity the activities or transactions which give rise to distortion and must explain how distortion arises from such activities or transactions.

C. In numerous decisions, the Tax Appeals Tribunal has held that, in determining whether a taxpayer has rebutted the presumption of distortion arising from substantial intercorporate transactions, it is appropriate to apply the principles of IRC § 482 and the regulations thereunder (***see***, ***Matter of Sears, Roebuck & Co.***, Tax Appeals Tribunal, April 28, 1994; ***Matter of Campbell Sales Co.***, Tax Appeals Tribunal, December 2, 1993; ***Matter of Medtronic, Inc.***, Tax Appeals Tribunal, September 23, 1993).

Treas Reg § 1.482-1(b)(1) provides, in relevant part, as follows:

> In determining the true taxable income of a controlled taxpayer, the

> standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

Treas Reg § 1.482-1(c)(1) provides that "[t]he arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."

Treas Reg § 1.482-1(c)(2) states that:

> in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis.

Treas Reg § 1.482-1(d) sets forth the factors which affect comparability under a particular method. These factors include: functions, contractual terms, risks, economic conditions, and property or services.

D. Treas Reg § 1.482-1(e)(2)(ii), which sets forth the criteria for the selection of comparables, provides as follows:

> Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

The report prepared by Price Waterhouse LLP, under the direction of Larry L. Dildine (***see,*** Finding of Fact "47"), must, therefore, be examined in light of these regulations to determine whether the results of two analyses performed by Mr. Dildine were sufficient to rebut the presumption of distortion, i.e., whether the transactions between TPS and TPI were at arm's length.

E. The first test performed was a comparable profits method, or CPM, in which 14 companies were ultimately selected as comparables (***see***, Finding of Fact "51"). Using return on sales (ROS) as the profit level indicator, TPS's profitability was compared to that of the 14 companies deemed comparable by Mr. Dildine. For the reasons discussed below, it must be found that this first test was sufficiently flawed so as to bring into question its reliability. That being the case, it cannot be found that the first CPM test was sufficient to rebut the presumption of distortion.

The businesses examined on the various computer databases and ultimately selected by Mr. Dildine as comparables were wholesale distributors of groceries and related products. However, as indicated in Findings of Fact "56" and "57", several of these companies were substantially different in function and operation from TPS. Some of the alleged comparables were involved in growing, manufacturing and other forms of production. TPS was not involved in producing a product for sale. Yet, there is no evidence that any adjustments were made by Mr. Dildine to improve the reliability of the results of this CPM test.

As the Division correctly notes, there were some inconsistencies in method application in the first CPM test. While the report indicates that companies in a start-up situation were rejected as comparables, the fact is that Mr. Dildine utilized sales figures from companies which, for one reason or another, were in the midst of starting up or which had made recent acquisitions that had

an obvious effect on sales figures. For example, the 10-K filed by Krantor Corporation (***see,*** Finding of Fact "61") indicates that 1989 was its start-up year and, accordingly, that the comparative results from 1989 and 1990 were "not very meaningful." Yet, despite the fact that it had negative returns on sales for those years, Krantor Corporation was still selected as a comparable. The form 10-K filed by Vestro Foods, Inc. (***see***, Finding of Fact "62") notes its acquisitions of specialty food companies and indicates that its results for the years 1987 through 1990 were affected by these acquisitions. While Mr. Dildine indicated that the year 1991 for Atlantic Beverage Company, Inc. was not included because it had acquired some additional businesses during the year (***see,*** Finding of Fact "63"), his report utilized Atlantic's return on sales for 1991 in its calculations.

While start-ups can, in fact, be used as comparables, Treas Reg § 1.482-5(c)(2)(i), which specifically addresses the comparable profits method utilized by Mr. Dildine, states, in relevant part, as follows:

> The determination of the degree of comparability between the tested party and the uncontrolled taxpayer depends upon all the relevant facts and circumstances, including the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, *and the stage in a business or product cycle* (emphasis added).

Treas Reg § 1.482-5(c) (2)(iii) notes that "operating profit may be affected by. . . differences in business experience (such as whether the business is in a start-up phase or is mature) . . . . Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected." The regulations go on to state that where there are such differences between the tested party and an uncontrolled comparable that would materially affect the profits determined under the relevant profit level indicator,

adjustments should be made pursuant to the regulations (Treas Reg § 1.482-5[c][2][iv]). Despite these provisions, there is no indication that Mr. Dildine made any adjustments to account for the start-up or acquisition factors present in the companies selected as comparables.

Purchasing co-ops were used as comparables in the first CPM analysis (***see***, Finding of Fact "64") despite Mr. Dildine's acknowledgment that a purchasing co-op is related to its customers and that not all co-ops maximize profits. He admitted that no steps were taken to determine the kind of cooperative agreements which existed between the co-ops used in the analysis and its shareholders. The results obtained from the financial reports of Certified Grocers of California, Ltd. and Roundy's , Inc. were clearly less reliable than those obtained from companies which sold strictly to unrelated parties (and were, therefore, truly uncontrolled transactions) and likely should have been excluded. At the very least, adjustments should have been made to attempt to account for the co-op factor.

F. Some other problems with the first CPM analysis are also apparent. Clearly, of the 14 companies selected as comparables, only 4 (***see***, Finding of Fact "51") operated in an East coast market. The regulations note that in determining the degree of comparability between controlled and uncontrolled transactions, one of the significant factors which could affect the prices that would be charged or paid, or the profit that would be earned, is the similarity of geographic markets (Treas Reg § 1.482-1[d][3][iv][A]).

Clearly, the most critical flaw in the first CPM analysis is the fact that it chose to focus only on TPS's distribution function while ignoring its other significant activities, i.e., transportation and marketing. Mr. Dildine's report acknowledged (***see***, Finding of Fact "50") that "TPS has principally the functions of transportation, marketing and distribution," yet the analysis failed to take that into account.

Finally, the profit level indicator selected, return on sales, or ROS, measures the ratio of operating profits to net sales (after returns and allowances). Mr. Dildine calculated ROS ratios on the sample of companies deemed comparable by using the information provided from SEC filed reports and by applying that ratio for each of the years at issue. He computed an interquartile range and, because the ROS for TPI fell within the interquartile range for the sample companies, the report concluded that intercompany transactions between TPI and TPS were conducted at arm's length under the standards of IRC § 482. However, as is noted in the regulations, functional comparability is an extremely important factor. Treas Reg § 1.482-5(b)(4)(ii) provides:

> Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's length result.

For the reasons set forth herein, it must be found that the first CPM analysis performed by Mr. Dildine was sufficiently flawed so as to render it an unreliable measure of an arm's-length result in dealings between TPI and TPS. Accordingly, this test does not rebut the presumption of distortion arising from the substantial intercorporate transactions between TPI and TPS.

G. In the second CPM analysis, Mr. Dildine attempted to evaluate TPS as a service provider for each of the services (distribution, transportation and marketing) which TPS provided for TPI. This second test took TPS's costs for providing each of the three services, multiplied by a markup which was derived from groups of deemed comparable businesses performing each of these services and arrived at what the report called "the minimum arm's length profit that should

be earned by TPS for these three services." As will be discussed herein, this second CPM was also so flawed as to render it an unreliable measure of whether dealings between TPS and TPI were at arm's length during the years at issue.

As to the distribution function, Mr. Dildine selected just two companies, B.K. Miller and Atlantic Beverage Company, Inc.. Each of these companies is a distributor of Tropicana products in the Baltimore-Washington, D.C. area. It again must be pointed out that the two companies operated out of the Baltimore-Washington, D.C. market, one which was clearly different from the market of TPS (***see***, Conclusion of Law "E"). The computations relating to B.K. Miller which were used in this analysis were derived from financial statements from 1989 and 1990 (no financial statements were furnished for 1991) provided by B.K. Miller to TPS. Admittedly (***see***, Finding of Fact "66"), they were not certified, audited financial statements and Mr. Dildine took no independent steps to verify their accuracy. Of perhaps greater significance was the fact that the figures utilized by Mr. Dildine to analyze TPS's distribution function were not actual distribution costs, but instead were calculated by subtracting the transportation and advertising expenses from the total operating expenses set forth in TPS's financial report (***see***, Finding of Fact "73"). As correctly noted by the Division, this "residual" figure means that expenses such as wages and salaries, depreciation and rent were all treated as "distribution" costs in this analysis, thereby calling into serious question its reliability.

Regarding the transportation portion of the test, Mr. Dildine chose, as potential comparables, a group of companies engaged strictly in freight forwarding (***see***, Finding of Fact "68"). As noted therein, freight forwarders arrange transportation for their customers but, normally, do not provide the actual transportation. This is quite unlike TPS which owned trucks and rail cars and which transported the Tropicana product from Florida to the Northeast market.

For the marketing services function, 7 companies were selected out of an initial group of 27 companies found through a computer search of advertising agencies. As was the case for each of the services analyzed, a median markup on total costs and an interquartile range of markup on total costs were computed. By applying what Mr. Dildine found was the arm's-length markup on total costs of the comparables to TPS's actual costs for its own distribution, transportation and advertising or marketing activities, he determined that TPS's average profit for the years at issue would have been $9.7 million. The actual profit reported by TPS for this period was $10.1 million. Therefore, because actual profit exceeded the constructive profit using the arm's-length markup on total cost for the sample companies, the report concluded that the prices between TPI and TPS were at arm's length.

H. In addition to the particular flaws set forth above, this second CPM test apparently utilized two profit level indicators. In the distribution portion of the test, the markup calculation was done by dividing operating income by operating expenses, not total expenses (***see***, Finding of Fact "74"). For the remaining portions of the test, i.e., the transportation and advertising functions, the markup calculation was done by dividing operating income by *total* expenses. As a result of this calculation error, different profit level indicators were employed within the same analysis.

Also of significance is the fact that Mr. Dildine chose, in this second CPM test, to compare the profitability of TPS to three separate and distinct types of businesses to attempt to confirm the results of his first CPM test, i.e., that the transactions between TPI and TPS were at arm's length. In the first test, he completely ignored the fact that TPS was engaged in considerably more than distribution of groceries and related products; it also performed considerable transportation and marketing services for TPI. To allegedly compensate for the fact that the first

test completely omitted any consideration of these other functions of TPS, the second test compared the profitability of TPS with companies engaged *solely* in these individual functions. Just how TPS can logically be compared to companies such as freight forwarders or advertising agencies which bear only the slightest resemblance to TPS was not adequately explained by the report or by the testimony of Mr. Dildine. This cannot be what was contemplated by the IRC § 482 regulations in setting forth the criteria for selecting uncontrolled comparables. Even if some of the companies utilized by Mr. Dildine could be deemed acceptable for use as comparables, clearly, as set forth in Treas Reg § 1.482-1(e)(2)(ii), the material differences between the controlled and uncontrolled transactions require that adjustments be made to improve the reliability of the results. There is no evidence that any such adjustments were made by Mr. Dildine. Since it is hereby found that the level of comparability in the second CPM test was low and, accordingly, that the results were not reliable due both to that fact as well as the numerous other flaws noted herein, this test (as well as the first CPM test) does not rebut the presumption of distortion arising from the substantial intercorporate transactions between TPI and TPS. As a result, it is hereby determined that, pursuant to Tax Law § 211(4) and the regulations promulgated thereunder, the Division properly denied TPS's claims for refund which had been filed based upon its contention that TPS and TPI should be allowed to file on a separate basis.

I. TPS maintains that there is no basis for the Division's requiring that it file a combined report which includes PSI since the prices between TPI and PSI were, on an overall basis, at arm's length. The factors cited by TPS in support of its position that there was arm's-length pricing between TPI and PSI, despite the fact that PSI acquires the orange peels which it utilizes in its cattle feed production operation from TPI at no cost, include the following: (1) prior to the

commencement of PSI's operation, TPI incurred a cost to dispose of its wet peel; (2) another producer of the wet peel by-product was, in some years, forced to give it away: (3) the wet peel is highly perishable and, as a result, has a very limited market; (4) the costs of shipping the wet peel are prohibitive; (5) the combination of the perishable nature of the wet peel and the high shipping costs require that any customers for the peel be located in TPI's immediate area: and (6) there are no other processors of wet peel anywhere in the area who could have purchased and processed the quantity of wet peel produced by TPI. In the alternative, TPS points to its computation (***see***, Finding of Fact "38") that the effect of combination is the same as would apply if TPI had charged PSI $14.00 per ton of wet peel, and since $14.00 per ton is an unsupportable price, the Division's adjustment creates greater distortion than exists on a separate report.

In response, the Division asserts that acting at arm's length, an orange processor (TPI) would not transfer all of its peels, for free, to a company, perform all of its nonproduction functions, lease it the site of its feed mill and then see the peels processor (PSI) earn a rate of return which is far in excess of its own. In support of that position, the Division points to the fact that PSI was a more profitable operation than was TPI, i.e., during the audit period, PSI's ratio of taxable income to total expenses plus cost of goods sold averaged 145% while TPI's averaged only 45% (***see***, Finding of Fact "45"). As additional support for its position, the Division points to the evidence in the record which indicates that TPI's peels were not worthless, but were, in fact, marketable for approximately $5.00 to $10.00 per wet ton.

J. There is no dispute that PSI acquired the orange peels from TPI at no cost. While it is true that the market for wet peel is very limited due to the prohibitive transportation costs, the perishability of the wet peel and the fact that the market is restricted only to Florida (***see***, Finding of Fact "38"), there was, nonetheless, a market for the peel. Clearly, it was not worthless. Juice

Bowl, an unrelated processor of citrus juice, sold its wet peel to a third party, Sun Pac. The average price paid by Sun Pac to Juice Bowl for the year 1990 was $5.80 per ton of wet peel. While it is true that the net price received by Juice Bowl was just $2.10 per ton for that year, this was due to the fact that the agreement between the companies required Juice Bowl to bear the cost of transportation (this cost was $3.70 per ton). Since the wet peel arrives at PSI's production facility (which is on the premises of TPI) directly from TPI on a conveyor, there were no transportation costs which would have reduced the amounts realized by TPI had this been an arm's-length, uncontrolled transaction rather than, as in the present matter, a controlled transaction. Moreover, the price which Juice Bowl received for the wet peel remained relatively constant during the audit period despite the fact that there is evidence in the record that, over the course of a number of years, the price fluctuated considerably. TPI's Manager of Citrus Comodities, Penelope Durham, testified that during the years at issue, the market price for wet peel was between $5.00 and $10.00 per wet ton. The facts that, prior to the commencement of PSI's operation, TPI incurred a cost to dispose of its waste orange peels and that, in some years, sellers of wet peel received nothing for it are inconsequential in light of the $5.00 to $10.00 price range during 1989 through 1991.

In addition to the fact that PSI received wet peel from TPI at no cost, despite its value at between $5.00 and $10.00 per ton, there are a number of other facts which, when considered collectively, lead to the conclusion that the transactions between TPI and PSI were not at arm's length.

Prior to 1990, PSI was required to pay TPI the sum of $18,750.00 per month, or $225,000.00 per year, for the services which it performed for PSI. In 1990 and 1991, TPI charged PSI $125,000.00 per year for these services. The services performed by TPI for PSI

included freight service, payroll services, customer billing, contract negotiation and credit checking. There is no indication in the record as to the reason for the substantial reduction in the annual fee for the services nor is there any evidence as to the fair market value of these services. While petitioner points to the fact that the fee more than adequately covered Ms. Durham's salary (which, during these years was approximately $35,000.00 per year), it is not clear how many of TPI's employees were engaged in performing services for PSI, how much of their time was spent on PSI business and whether the fees received by TPI were alone sufficient to compensate these other employees.

Additionally, there were various lease agreements between TPI and PSI under which PSI leased certain delivery equipment used to distribute its feed products as well as the feed mill and feed warehouse. While the rent for the feed mill and warehouse was $1,100.00 per month, there was no evidence presented as to whether this was an arm's length, fair market rent. Because PSI's operation is located on the premises of TPI, energy costs associated with PSI's production equipment were allocated to PSI. Again, however, there was no evidence presented to show that such allocation was at arm's length.

While, as noted above (***see***, Conclusion of Law "I"), the Division makes much of the fact that the TPI-PSI transactions were not at arm's length based upon the comparison in profitability between TPI and PSI (citing the ratio of taxable income to total expense plus cost of goods sold), that is not the basis for the ultimate conclusion that the presumption of distortion arising from the substantial intercorporate transactions between TPI and PSI has not been rebutted. The reasons for this conclusion having been reached is that petitioner has failed to prove that the transactions between TPI and PSI were at arm's length. PSI received wet peel from TPI at no cost. It received from TPI considerable administrative services, certain equipment, use of facilities and

energy to run production equipment. As to the wet peel, it has heretofore been established that the market price, during the audit period was $5.00 to $10.00 per wet ton (with no reduction for transportation or handling cost necessary due to the location of PSI's facilities). Clearly, TPI's transfer of the peel at no charge cannot be found to be at arm's length. With respect to the services, equipment and facilities provided by TPI to PSI, there has been no evidence presented from which it can be reasonably concluded that the charges to PSI were consistent with what would have been charged by TPI if it had been dealing at arm's length with an uncontrolled party.

K. 20 NYCRR 6-2.3(e) provides as follows:

> Notwithstanding the fact that the members of one or more existing or proposed combined group or groups of corporations within an entire group meet [the regulatory requirements for combination], the Tax Commission may permit or require a different combination of such corporations within such entire group with respect to a combined report if any such different combination or combinations . . . would result in less distortion of the activities, business, income or capital in New York State of such corporations within the entire group.

In its brief, petitioner contends that, even if the transfer of feed from TPI to PSI was at less than an arm's-length price, the Division's adjustment, which petitioner maintains results in a $14.00 per ton adjustment (***see***, Finding of Fact "38"), leads to an even greater distortion and, based upon 20 NYCRR 6-2.3(e), bars such forced combination. Petitioner's argument is without merit.

While it is true that there is no evidence to support a $14.00 per ton of wet peel price, the Division, in its brief, asserts that the computation of TPS's former tax manager, Henry Marchman, is not evidence of the fact that the Division is imputing a $14.00 per ton transfer price.

At the hearing, Mr. Marchman explained how he derived the figure on his worksheet which is referred to as "entry to taxable income" which he stated is the proposed adjustment by the Division or the amount of income which has been added to the combined report as a result of the Division's proposed combination of PSI with the others in the Tropicana group. "Entry to taxable income" is the result obtained by multiplying the total tons of dry feed sold (as set forth on the worksheet) by the conversion factor of 5 (which represents the number of tons of wet peel required to produce a ton of dry feed and which is, therefore, the number of tons of wet peel transferred by TPI to PSI for the year) and then by the "required allocation of fruit cost" which the worksheet indicates is $14.00 for each of the years at issue.[5] When subsequently asked if the equivalent price per ton could be calculated once the total tons sold and taxable income adjustment are known, Mr. Marchman answered in the affirmative and stated that this was the basic purpose of the worksheet. Taking the "entry to taxable income," dividing by the wet tons to dry tons factor of 5 and then dividing by the total tons of dry feed sold, results in a $14.00 "equivalent price per ton" adjustment. The flaw in this computation appears to be the fact that "entry to taxable income" is derived, as explained above, by using the $14.00 "required allocation of fruit cost." The "required allocation of fruit cost" and the "equivalent price per ton" are one in the same, yet one is used to compute the other.

Even if, however, this computation were not flawed, its result does not support petitioner's contention, i.e., that the effect of adding to the combined group the income of PSI, is the same as

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[5]It is unclear as to how this "required allocation of fruit cost" was computed. However, the Division, in its brief, explains that it was computed by dividing the figure referred to as the "entry to taxable income" which Mr. Marchman explained represented the amount of income which has been added to the combined report as a result of the Division's proposed adjustment, by the number of wet tons transferred by TPI to PSI for that particular year. For example, for the fiscal year ended July 1989, the entry to taxable income ($10,269,920.00) when divided by the number of tons transferred by TPI to PSI (733,565.7) equals 13.999, or 14.00. This computation yields the same result when performed for each of the three years at issue.

would apply if TPI had charged PSI $14.00 per ton for wet peel. As the Division, in its brief points out, the worksheet (if its computations are to be accepted) establishes only that, in adding PSI's income to that of the Tropicana group, and dividing by the number of wet tons transferred by TPI to PSI, a profit of $14.00 above PSI's expenses is being earned per wet ton transferred. Since petitioner has failed to provide evidence that the transactions between TPI and PSI were at arm's length, most notably with respect to charges for administrative services, lease charges for space, equipment and energy, it could reasonably be inferred that this $14.00 above costs was attributable to TPI's undercharging PSI in any or all of these areas. In any event, absent proof of arm's-length pricing between TPI and PSI, it cannot be found that the Division has, by virtue of its requiring PSI to be included in a combined report, imposed a $14.00 per wet ton transfer price.

Even, assuming *arguendo*, that petitioner's contention that the Division's requiring the inclusion of PSI did, in fact, impose a $14.00 per wet ton transfer price, its assertion that more distortion results from including PSI in the combined report than from excluding it fails for lack of proof. The record discloses that, while the price for wet peel did fluctuate considerably, the price during the years at issue was between $5.00 and $10.00 per wet ton (***see***, Finding of Fact "42"). Clearly, the upper end of that range is closer to the $14.00 per wet ton price which it is claimed that the Division is imputing, than it is to the $0.00 which TPI charged to PSI for the peel. In any event, petitioner has failed to prove: (1) that the Division imposed a $14.00 per wet ton transfer price; and (2) that requiring the inclusion of PSI in a combined report with the Tropicana group creates more distortion than would its exclusion, thereby barring such forced combination pursuant to 20 NYCRR 6-2.3(e).

L. Finally, TPS contends that the Division, by requiring TPS to file on a combined basis

with TPI and PSI, is in violation of the Due Process Clause and the Commerce Clause of the United States Constitution. The basis of this contention is that, if the Division was to prevail in its forced combination, New York State would be taxing income of TPI and PSI that was earned outside of its borders, something which is prohibited by the United States Constitution.

In response, the Division maintains that, in requiring TPS to include the income and allocation factors of TPI and PSI, the Division is not taxing TPI or PSI. Therefore, it is of no consequence that neither TPI nor PSI do business in New York. It is the Division's position that it is merely attempting to accurately depict TPS's New York income through the unitary method which involves including in TPS's income, the entire income of the unitary business of which it is a part, and by applying its three-factor allocation formula as provided for in Tax Law § 211(4).[6]

TPS does not, for the years at issue, contest that it, TPI and PSI constituted a unitary business involving the production and sale of juice, juice-based beverages and cattle feed made from orange by-products (***see***, Finding of Fact "8"). Furthermore, TPS does not contest that it had substantial intercorporate transactions with both TPI and PSI (***see***, Finding of Fact "9") within the meaning of 20 NYCRR 6-2.3(b).

In ***Mobil Oil Corp. v. Commissioner of Taxes of Vermont*** (445 US 425, 63 L Ed 2d 510), the United States Supreme Court noted that the entire net income of a corporation, which is generated by interstate as well as intrastate activities, may be fairly apportioned among the states for tax purposes by formulas which utilize in-state aspects of interstate affairs. The Court stated: "For a State to tax income generated in interstate commerce, the Due Process Clause of the

[6]In the case of combined reports, the tax is measured by combined entire net income, combined minimum taxable income, combined pre-1990 minimum taxable income or combined business and investment capital.

Fourteenth Amendment imposes two requirements: a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." (***Id.*** at 436, 437, 63 L Ed 2d at 520).

For purposes of satisfying the Due Process Clause of the Fourteenth Amendment as to state income taxation, the linchpin of apportionability establishing a taxpayer's tax liability in appropriate proportion to the taxpayer's business transaction in the state is the unitary business principle that the taxpayer's intrastate and extra state activities form part of a single unitary business (***Mobil Oil Corp. v. Commissioner of Taxes of Vermont***, ***supra***). As noted previously herein, TPS is not contesting that the three corporations constitute a unitary business. As to TPI, it is clear that it reaps the benefit of a New York State market for its juice products which are marketed and distributed by TPS from its New York locations. Although PSI sells no feed to New York customers as its domestic market is limited to Florida, there was no evidence presented with respect to PSI's market for its industrial cleaning product, D'limonent (***see***, Finding of Fact "36"). It is clearly intertwined with TPI and is dependent upon TPI for its operation and its profitability. It reaps the benefit of a large and continuous supply of wet peel from which it produces its cattle feed and it enjoys the benefits (both logistic and financial) of being located on TPI's premises. While it does not sell anything to or buy anything from TPS, it is TPS's transporting, marketing and distributing of the TPS/TPI group's product that allows TPI to be the largest processor of Florida oranges (***see***, Finding of Fact "12") and, accordingly, to be the largest producer of wet peel. While it is true that, as a general principle, a state may not tax value earned outside its borders, the inquiry which must be made is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can

ask return" (***Wisconsin v. J.C. Penney Co.***, 311 US 435, 444, 85 L Ed 267). In the present matter, more than a third of TPS's U.S. sales are in the Northeast, with most of those sales to the metropolitan New York area (***see,*** Finding of Fact "24"***).*** Certainly then, New York is justified in imposing its franchise tax upon the unitary Tropicana business group.

It is a well-settled principle that a taxpayer claiming immunity from a tax has the burden of establishing his exemption (***Norton Co. V. Department of Revenue***, 340 US 534, 95 L Ed 517). In particular, a taxpayer challenging a state tax that employs the unitary business principle and formula apportionment in applying a corporate franchise tax to corporations doing business both inside and outside the state has the burden of demonstrating that there is no rational relationship between the income attributed to the state and the intrastate values of the enterprise by proving that the income apportioned to the state is out of all appropriate proportion to the business transacted in that state (***Container Corp. of America v. Franchise Tax Board***, 463 US 159, 77 L Ed 2d 545). Other than a mere general assertion that a forced combination by the Division results in taxation of the income of TPI and PSI earned outside of the borders of New York State, TPS has offered no proof regarding apportionment of income in relation to business transacted in the State.

The tax imposed upon the Tropicana group by New York, pursuant to its "forced" combination, does not violate the Commerce Clause of the United States Constitution. Clearly, the state of "commercial domicile" of TPI and PSI, the State of Florida, has the authority to impose a tax on the income of these corporations. No reason has been shown why that authority should be exclusive when such income is reflective of a unitary business, part of which is conducted in other states (***Mobil Oil Corp. v. Commissioner of Taxes of Vermont***, ***supra***).

Under the Commerce Clause, a formula apportioning the income of a unitary business

within and without a state for tax purposes must not result in discrimination against interstate or foreign commerce. However, the Constitution does not invalidate a formula apportioning the income of a unitary business merely because it may result in taxation of some income that did not have its source in the taxing state (***Container Corp. Of America v. Franchise Tax Board***, ***supra***). The taxpayer, in order to invoke the protection of the Commerce Clause, must sustain its burden of proving, by clear and cogent evidence, that the state tax results in extraterritorial values being taxed (***Exxon Corp. v. Wisconsin Dept. of Revenue***, 447 US 207, 65 L Ed 2d 66). No such proof has been presented in this matter. Accordingly, petitioner's contentions that the Division's "forced" combinations violate the Due Process Clause and the Commerce Clause of the United States Constitutions are found to be without merit.

M. The petition of Tropicana Products Sales, Inc. is denied; the Notice of Deficiency dated April 11, 1994 is sustained; and petitioner's refund claims are hereby denied.

DATED: Troy, New York
November 25, 1998

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE