STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

PANAVISION, INC. :

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1991. :

DETERMINATION
DTA NO. 816660

Petitioner, Panavision, Inc., c/o Ernst & Young, LLP, 787 7th Avenue, Room 1729, New York, New York 10019, 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 year 1991.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York 10022, on July 13, 1999, at 10:30 A.M., and continued to its conclusion on July 14, 1999, commencing at 9:15 A.M., with all briefs to be submitted by January 14, 2000, which date began the six-month period for the issuance of this determination. Petitioner appeared by Ernst & Young, LLP (John O. Michaelson, Esq., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel).

ISSUES[1]

I. Whether the statute of limitations prevents the Division of Taxation from assessing Panavision, Inc. on a separate company basis.

II. Whether the Division of Taxation properly determined that Panavision, Inc. should file its New York State corporation franchise tax reports on a separate basis. In addressing this question, the following must be considered:

A. Whether Panavision, Lee Panavision International, Inc. and five other subsidiaries of Lee Panavision International, Inc. were part of a unitary business.

B. Whether Panavision has shown that filing its New York State corporation franchise tax returns on a separate basis results in distortion of income.

III. Whether Panavision has carried its burden of proof with regard to the abatement of penalties.

FINDINGS OF FACT

1. During 1991, Panavision, Inc. ("petitioner" or "Panavision") operated as a designer, manufacturer and distributor of film camera systems for the motion picture and television industries. Panavision handled the leasing of its systems to both end-user customers and to related[2] and unrelated distributors, who in turn rented them to end-users, generally represented by producers of entertainment products. Unrelated distributors received training and support to

---

[1] Petitioner requests an award of costs and fees pursuant to Tax Law § 3030 in its petition. However, until such time as a final determination exists with respect to the tax, it is premature to make a determination as to whether a party is a prevailing party (Tax Law § 3030[c][5][C]).

[2] There was no evidence introduced that a related distributor referred to any of the companies proposed for combination.

insure that Panavision's customers received the same high level of service that they would receive from the company itself. Additionally, petitioner leased movie camera lines other than its own.

The camera systems were used in feature films, commercials, episodic television, movies of the week and other activities. The company maintained an inventory of non-Panavision cameras in its product offerings in addition to its own brand, which gave Panavision an edge over its competitors, which were few. One of the lenses manufactured by Panavision was considered state of the art. Its manufacturing facility was located in Tarzana, California, and its primary domestic marketing target was Los Angeles, California. There were also shops located in Hollywood, California and Orlando, Florida. Panavision maintained an international division run by Panavision Europe, which was headquartered in England, and made up of several other companies. Panavision's sales representatives in all of the varied locations worked closely with its customers by developing close relationships with cinematographers, directors and producers. During the first five months of 1991, Panavision earned revenue in the amount of $26.7 million and employed about 400 people, including some 30 engineers, draftsmen and machinists in the design and development process. During the period in question, 1991, petitioner was the wholly-owned subsidiary of Lee International Acquisitions, whose stock was owned 100% by Lee Panavision International, Inc. ("LPI"),[3] which became Lee International, Inc. after June 1, 1991.

---

[3] The testimony provided at the hearing and the documents conflict as to whether LPI was in direct ownership of Panavision or whether Lee International Acquisitions was an intermediary holding company between LPI and Panavision. Of the number of times this issue arises, more frequently the position is taken that Lee International Acquisitions was in direct ownership of Panavision's stock, with LPI holding the stock of Lee International Acquisitions. For purposes of discussion, this will be assumed to have been the case.

2. LPI, Panavision, Lee Lighting America, Ltd., Lee Colortran Holdings, Inc., Lee Colortran, Inc., Lee America West, Ltd., and Lee International Acquisitions, Inc. filed a New York State Combined Franchise Tax Return (Form CT-3-A) for the tax year ended December 31, 1991, on or about December 15, 1992. All the entities were calendar year corporations. At the time of filing, LPI and its subsidiaries attached to the combined return a request for them to be allowed to file on a combined basis. The business and activities of the corporations were outlined in the attachment. The combined filing documents indicate that Lee Colortran Holdings and Lee Lighting own 100% of the stock of Lee Colortran and Lee America West, respectively. LPI owns 100% of the stock of Lee International Acquisitions, which in turn holds the shares of Lee Colortran Holdings and Panavision. Although the attachment describes the proposed group of companies as having operated as a unitary business since December 16, 1988, prior to tax year 1991, petitioner had not filed, or requested to file, on a combined basis with LPI or its affiliates.

The Combined Franchise Tax Return, Form CT-3A, shows separate and combined alternative business income for allocation for each of the seven companies as follows:

LPI	$ -43,946,209
Lee Lighting America	-1,597,057
Lee Colortran Holdings	121,538
Lee Colortran	-4,056,781
Lee America West	122,606
Lee International Acquisitions	-2,057,244
Panavision	58,455,202

In addition, a New York State capital loss carry forward in the amount of $2,400,000.00 from LPI was also a factor in the computation of combined alternative business income, which ultimately formed the basis for the corporate franchise tax computed on combination.

3. Lee Colortran and Lee Lighting America were involved in the manufacture and distribution of lighting equipment for motion picture, television, theater and studio businesses. A press release described Lee Lighting America as a London-based company which acted as the largest supplier in Europe of rental lighting equipment to the motion picture and television industries. Panavision and Lee Lighting America shared rental space in Orlando, Florida, which was leased by Lee Lighting America. There Lee Lighting America sold lighting equipment and Panavision leased camera equipment. Panavision paid Lee Lighting America for a proportion of the lease, but the terms were not made a part of the record. Each employed seven or eight people in that location. Panavision handled the administration of accounts payable for the Orlando store for both companies, without a charge back to Lee Lighting America.

4. Lee America West, although still incorporated as a legal entity during 1991, was inactive during the audit period.

5. Commencing in 1996, the Division of Taxation ("Division") conducted a field audit of petitioner for the period January 1, 1991 through December 31, 1991 ("the audit period"). Petitioner executed several consents extending the statute of limitations to assess the corporation franchise tax allegedly due. The latest extended the statute of limitations to assess corporation franchise tax for the audit period until April 30, 1998. As a result of the audit, the Division issued to petitioner a Notice of Deficiency dated April 20, 1998, asserting a deficiency of New York State corporation franchise tax (which would have been associated with the filing of Form CT-3, a separate corporation franchise tax return) in the amount of $260,178.00, plus penalties and interest in the amounts of $27,318.85 and $156,755.63, respectively, and franchise taxes which would have been due pursuant to the filing of Form CT-3M/4M in the amount of

$58,461.00, plus penalties and interest in the amounts of $4,038.30 and $23,173.04, respectively, for a total assessment of $509,923.82. The basis for the notice was the assertion by the Division that Panavision should have filed its 1991 New York State franchise report on a separate basis.

There has been no assertion or evidence that any of the other six entities seeking combination with Panavision was issued an assessment.

6. On or about July 17, 1998, petitioner, by its representatives, filed a timely petition before the Division of Tax Appeals, protesting the notice of deficiency. Petitioner asserted it should be allowed to file on a combined basis with LPI, that all penalties should be abated, and all costs and legal fees incurred be reimbursed pursuant to Tax Law § 3030.

7. The Division filed its answer on or about October 8, 1998, which affirmed common ownership among the proposed combined entities, but denied the existence of a unitary relationship and the existence of distortion if the companies filed on a separate reporting basis.

8. LPI and its many subsidiaries ("the Lee group")[4] have operated as a group since December 16, 1988, when Lee International, Ltd., the parent company at that time, acquired its subsidiaries. Lee International, Ltd. incurred approximately $340 million in debt in late 1987 to take Lee International, PLC, a company then trading on the London Stock Exchange, to private company status by buying back its publicly held shares, to purchase Panavision (for approximately $110 million) and restructure its existing debt. After Lee International, PLC went

[4] Additional subsidiaries were set forth in a corporate chart depicting the entire Lee group, and submitted into evidence as an attachment to the expert's Transfer Pricing Report. It encompasses approximately 30 additional corporations, some inactive, that were not a part of the proposed combined filing.

private, it was renamed Lee International, Ltd. Lee International, Ltd. became a subsidiary of the parent holding company, LPI, incorporated in Delaware in July 1988.

In order to induce loans and cash advances, the lenders, the primary one being Citicorp Industrial Credit, Inc. ("Citicorp"), required the Lee group to execute a pledge agreement whereby Lee America West, Lee Colortran, Lee Colortran Holdings, Lee Lighting America, Panavision and Lee International Acquisitions pledged their stock as collateral for the debt. If any of the companies whose stock was pledged as collateral paid dividends, to the extent the dividends were not prohibited by the original credit agreement, the dividends became a part of the pledged collateral. The original credit agreement was not made a part of the record.

By early 1988, the Lee group was in default of the loan, having insufficient cash to make the interest payments. Citicorp, the largest lender, approached the New York fund management group Warburg Pincus Capital Group ("Warburg Pincus") to participate in operating and restructuring the company. Warburg Pincus stepped in and made an investment of $60 million, proceeded to take over the group and hired a new management team, led by William C. Scott. Mr. Pincus, having been previously acquainted with Mr. Scott's background, gave Mr. Scott complete authority to act on his behalf as a 90% shareholder. By 1991, Mr. Scott owned the other 10% of LPI. At the time Mr. Scott joined the Lee group, he was given the task of cleaning up the company that was headquartered in London and improving on the operations of Panavision, which he considered the "gem of the group." The ultimate goal was to eventually take Panavision public, which actually took place in 1996.

9. William C. Scott was appointed chairman, president and CEO of LPI and Lee International Acquisitions, the two holding companies that directly or indirectly owned

Panavision and the other five companies involved in the combination which is the subject of this matter. He became affiliated with LPI in December 1988 and remained with the group until his resignation as CEO and president of LPI in January 1999. Prior to his affiliation with LPI he was chief operating officer and president of a public company known as Western Pacific Industries, where he assisted the CEO in making acquisitions of other companies and then being responsible for their management.

10. Mr. Scott's responsibilities as CEO of LPI included management overview of the operations of virtually the entire Lee group. He provided management direction to Panavision through John Farrand; he was responsible for the appointment of all officers and directors at Panavision and LPI; he approved all capital expenditures at Lee and Panavision over $20,000.00; he approved hiring and firing of employees earning over $40,000.00; he would comment upon work policies at Panavision that may have needed revision; and he was compensated only by LPI. While Scott was at LPI for 1991, he frequently spoke with and visited people at Panavision. However, since he lived in New York, was based in London, and Panavision was located in California, he left the running of Panavision to John Farrand. He described his primary role with LPI as one responsible for rationalizing the assets. He was to close or sell off businesses that were not desirable to keep, and make the most of ones that were properly managed.

11. With respect to Mr. Scott's role in the negotiations with Citicorp and the bank group, he was the key person from the end of 1988 through the 1991 reorganization. During the restructuring in June 1991, he was the principal initiator of the LPI side of the negotiations.

12. In 1991, Mr. Scott had dealings with a company referred to as General Camera ("GC"). General Camera acted as an agent for Panavision for approximately 25 years. Panavision would ship cameras to GC, which would in turn rent the cameras to another user. GC would pay Panavision 60% of the revenues and keep 40% for itself. GC fell behind in its 60% payments and owed Panavision $1.5 to $2 million at one point. On behalf of Panavision Mr. Scott had discussions with GC concerning payment terms and UCC filings for guarantees. He was employed by LPI at this time and was not paid by Panavision for such negotiations.

13. Joseph McGonigle was the corporate controller of LPI and spent approximately one-half of his professional time on preparing financial reports and statutory filings. Other time was spent on Panavision matters in both the United States and Europe. Such matters were not detailed by petitioner in the record. As of May 1989, Mr. McGonigle served as secretary of Panavision. There is no mention of how long he held this position or what the office entailed.

Arthur Dignam, Chief Financial Officer of LPI, spent some of his time on the European branch of Panavision and a significant amount of time working with Mr. Scott and the banking group handling the debt. As of May 1989, he served as vice president of Panavision. There is no mention how long he held this position or what the office entailed.

Ronald Buchner was an analyst for LPI who spent a portion of his professional time on regulatory compliance. Similarly, Gary Goldner handled some regulatory compliance. Mr. Goldner also spent a portion of his professional time on Panavision matters in both the United States and Europe. These duties were not further detailed in the record. Buchner and Goldner did not report to Mr. Scott, but rather to Arthur Dignam and Joseph McGonigle.

Jeffrey Marcketta was LPI's vice president of corporate development. In 1991, he was actively involved with Mr. Scott in restructuring the Lee group businesses and the debt.

14. LPI did not receive compensation for any management services it provided Panavision or any of the other subsidiaries.

15. John Farrand, who had been with Panavision since 1985, is the current president and CEO of Panavision. In 1991, prior to the Lee group reorganization, he ran Panavision for Mr. Scott earning approximately $300,000.00. His responsibilities essentially encompassed running the day-to-day business of Panavision. There was also a management team at Panavision, consisting of Panavision employees compensated by petitioner. The key personnel were John Farrand, Phil Radian, Bob Harvey and Ian Neil. During 1991, Phil Radian was the head of the marketing department, reporting to John Farrand, and Robert Leeper was the chief financial officer of Panavision. No further information concerning these executives was established by the record. The management team was made up of an additional 10 to 20 individuals, whose names and duties were not provided.

16. Lee International, Ltd. was a holding company, and it was parent to some significant Panavision operations such as Panavision Europe, Panavision France and Panavision Italy. Panavision Europe, Ltd. held the stock of Lee Filters, Ltd., Panavision France, S.A., K.N.J., Ltd., Joe Dunion Cameras (Ireland), Ltd., and Panavision U.S.S.R., Ltd., all of which were operating companies. The president of Lee Filters reported to Mr. Scott. Panavision France (other than for a brief period), K.N.J., Ltd., Joe Dunion Cameras, and Panavision U.S.S.R., Ltd., reported up through the president of Panavision Europe to John Farrand. Mr. Scott would advise Mr. Farrand concerning these operations.

17. LPI performed a sweep of cash from Panavision, Lee Colortran and Lee Lighting America in an attempt to meet payments on its large corporate debt. As to Panavision's cash account, the sweep took place on a daily basis in 1991(and earlier years) whenever LPI needed the funds, unless the laws of a foreign country prevented the sweep. Mr. Scott, however, was unsure whether the sweep was performed daily, and was unfamiliar with its actual mechanics. He could not say with certainty if the transaction was recorded as a loan, though he believed it may have been. He was certain, however, that LPI got all the cash possible out of Panavision, and knew that LPI was making debt payments with the funds. LPI did not compensate Panavision in any way for the use of this money. There was no written evidence of the debt. Petitioner had no right to demand repayment of the cash swept, and Panavision's expectation of repayment was expressed in very vague terms on the record.

Between 1986 and 1991 Panavision was a very profitable company, with a great deal of excess cash, which it managed on its own before the sweep program was set up. Panavision did not benefit from the 1987 acquisition by Lee International. Regarding the cash sweeps, from a cash management perspective, Panavision derived some benefit only to the extent that its cash was being used to pay off debt of a related company, since Panavision had no debt of its own.

18. Christopher Phillips was employed by Panavision International between 1985 and early 1999. He assumed the position of controller in 1989, and held that position during the audit period. He remained with Panavision until 1999. Mr. Phillips was compensated by Panavision and, in 1991, reported directly to Robert Leeper, Panavision's CFO.

19. Mr. Phillips was in control of the treasury operations in the United States and responsible for making sure there were systems in place that would allow for the mechanical

sweep of cash to LPI, or what he referred to as the Lee intergroup. A zero balance account was set up to handle the mechanics of the transfers of funds. The cash sweeps commenced sometime in 1989, and Panavision had no authority to limit the amount of cash transferred to LPI, because as owner, LPI was in charge. Panavision understood that it was part of an overall group that had incurred a large bank debt, repayment of which would be handled in conjunction with the anticipated reorganization of the Lee group.

Management systems that were put in place required the accounting group to go on a new reporting system, and Mr. Phillips was responsible for making sure all divisional operations in the United States complied with that reporting accurately. Concerning cost controls, Mr. Phillips was required to have his disbursements preauthorized by Mr. McGonigle on a daily basis. In addition, a reporting chain was required to be maintained by Panavision to create a replacement or addition to staff, and all such changes had to be authorized by LPI.

20. Interest was paid on the original Lee group debt until the end of 1988 when another default occurred. Defaults on the debt continued until the companies underwent reorganization in June 1991. During this time LPI was not considered creditworthy, since its bond rating would be considered nonexistent, and the company had no ability to raise capital other than on an equity basis.

THE ERNST & YOUNG REPORT

21. Petitioner submitted into evidence a report entitled “Lee Panavision International, Transfer Pricing Study for the Period January 1, 1991 to May 31, 1991” (“the report”), prepared by the accounting firm of Ernst & Young, LLP, explained through the testimony of Elizabeth Galvin, a senior manager in the economic consulting practice of the firm. Ms. Galvin was

qualified as an expert in transfer pricing, specializing in state and local transfers and international transfer pricing. The report, prepared by Ms. Galvin for Panavision, examined two intercompany transactions between LPI and Panavision for the first five months of 1991, before the June 1, 1991 restructuring of the companies. Ms. Galvin analyzed the arm's length character of the following transactions:

1) The management services provided by LPI to Panavision for the five-month period; and

2) The transfer or advance of cash from Panavision to LPI over the same period, and the interest that may have been owed to Panavision for such transfers.

The principal objective of the report was to assist Panavision's management in determining the arm's length nature of intercompany transactions between LPI and other New York taxpayers within the Lee group for 1991, in compliance with Internal Revenue Code ("IRC") transfer pricing regulations set forth in IRC § 482.

Regarding the management services, Ms. Galvin's conclusion was that Panavision should have compensated LPI for the services, and in the absence of doing so, such services were not provided at arm's length. Concerning the transfer of cash from Panavision to LPI, she concluded such transactions were not arm's length because interest was not paid by LPI to Panavision. In addition, there were other transactions that may have resulted in distortion, such as loan guaranty agreements, cash collateral agreements and stock pledge agreements, which were not included in the report. These transactions were not included in Ms. Galvin's report because Panavision requested she specifically review only the two transactions identified as the subject of the report.

In preparation of the report, Ms. Galvin interviewed William Scott, Christopher Phillips and Jeff Marcketta, and reviewed a large number of documents, including the company's 10-K,

financial statements, tax returns, intercompany agreements and bank transactions. Ms. Galvin chose to apply the Final Treasury Regulation § 482 as the IRC regulation for her analysis, which applies to tax years after October 6, 1994. The portion of the regulations as relevant to this matter have not changed significantly since their original adoption, which precedes the 1991 transactions.

22. IRC § 482 is used to determine the arm's length transfer prices for transactions between members of an affiliated group. This is done to clearly reflect income attributable to controlled transactions. The final section 482 regulations provide several methods for determining intercompany prices, and require the "best" method be employed for each pricing situation, i.e., the method that produces the most reliable measure of an arm's length result for the controlled transaction, considering all of the facts and circumstances of that transaction. Although the report discussed five tangible assets' pricing methods,[5] the report employed the Benefit Test of Treasury Regulation § 1.482-2(b), which provides guidance on how to determine the arm's length charge for services performed by a member of a controlled group for another member of the group. An arm's length charge must be paid if the tested party passes the Benefit Test.

The Benefit Test is a method by which an allocation is made when an entity benefits from services rendered by a related party. However, no allocation is made if the probable benefits are so indirect or remote that unrelated parties would not have charged for the service or if the service is merely a duplication of a service which the related party has independently performed or is performing for itself. The Benefit Test was used to analyze the management services provided by LPI to Panavision.

[5] Since these pricing methods are not relevant to Ms. Galvin's analysis and conclusions, they are not discussed herein.

23. Ms. Galvin determined that LPI passed the Benefit Test for the following reasons:

* Benefits were expected from the services under review;

* The services under review which LPI provided to Panavision were not a duplication of other services; and

* The services under review were of a type for which an unrelated party would have charged.

24. In order to calculate an arm's length management fee, Ms. Galvin first determined the underlying costs incurred by LPI in providing these services. One method of determining such costs is to calculate the amount of time spent by employees in providing such services and to develop an allocation methodology based on time spent providing services to different entities. However, since time records for each executive were not maintained, and none of the LPI employees, other than Scott, were still employed by the company, it was not possible to precisely determine the amount of time spent by each employee rendering different services to different entities. Based on interviews with Scott, Marcketta and Phillips, Ms. Galvin derived the following percentages for stewardship services: McGonigle, 50%; Goldner, 50%; Buchner, 100%; and Dignam, 25%, for which an allocated expense would not be made to Panavision. Stewardship services, those which are duplicate in nature, tend to be services that a company or investor would undertake as an investor-related company that would not directly benefit the subsidiary or related companies. Stewardship services are the services one provides in the regular overseeing of the operations of a company, distinguished from general management and day-to-day services, which could provide a direct benefit. Stewardship services were provided to each of the Lee group entities at one time or another.

After the stewardship percentages were determined, the relevant percentage of each person's 1991 annual salary was allocated as to stewardship. Stewardship services over total salary as a fraction was equal to 16%, which was used to determine what percentage of LPI's total expenses for the five-month period ended May 31, 1991 should be allocated to stewardship.

All of LPI's operating expenses incurred for the five months ended May 31, 1991 ($1,138,720.00) were set forth in a schedule, less stewardship expenses (16% of total expenses). The following expenses comprised this schedule: compensation of officers, salaries and wages, rents, depreciation, taxes, travel and entertainment, professional fees, travel expense, bank fees, office expense, temporary services, messenger and delivery services, consultants, telephone, miscellaneous, equipment rental, employment agency fees, and electricity. LPI's total costs less stewardship expenses was pro-rated to each of 16 companies in the Lee group,[6] including Panavision, based upon the relationship each subsidiary's five-month sales (ending May 31, 1991) had to the consolidated group's five-month sales.[7] Based upon this method, Ms. Galvin allocated to each of the 16 entities a share of the costs incurred by LPI in providing management services for the five months ended May 31, 1991. Costs in the amount of $507,000.00 incurred by LPI were attributed to providing management services to Panavision, and this amount was determined by Ms. Galvin to be an arm's length fee for these services.

---

[6] The companies included are the following: Lee Colortran, Shepperton Studios, Panavision Espana, Lee Lighting (UK), Lee International, Ltd., Lee International, Inc., Lee Panavision, Ltd., Humphries Holdings, Lee Lighting America, Colortran, Ltd., Lee America West , Lee Colortran Holdings, Lee International Acquisitions, Lee International Films, MRI, Ltd. and Panavision.

[7] Panavision's pro-rata portion of total expenses was approximately 53% based on this ratio.

25. The expert's report applied Treasury Regulation § 1.482-2(a) in the analysis of intercompany loans. Such regulation provides that where one member of a group of controlled entities makes a loan or advance and, as in this case, charges no interest, an allocation which reflects an arm's length rate of interest for the use of such loan or advance may be made. The regulations further provide guidance on the concept of an arm's length rate of interest. The arm's length rate is the rate that would have been charged at the time that the indebtedness arose in independent transactions with or between unrelated parties under similar circumstances. It considers relevant factors such as the principal amount, loan duration, security involved, credit of the borrower and the interest rate prevailing at the site of the lender or creditor for comparable loans between unrelated parties. Ms. Galvin sought to determine a market rate which would have been charged to LPI for borrowing a similar level of funds from an unrelated party during the same period. The borrowing rate which LPI would have paid during this relevant time period was estimated. The prime rate, which is typically given to corporations with AAA credit ratings was not deemed comparable as an implied rating for LPI for the period 1989 to 1991 because LPI had defaulted on its loans in 1988, and was still in default in 1991. Thus, Ms. Galvin made an adjustment to the applicable average prime rate to reflect the credit risk which would have been borne by Panavision or a third party lending to LPI. The adjustment was calculated by evaluating the average spread between AAA corporate bonds and CCC corporate bonds over a number of years, to obtain a normalized average spread, based on reliable and available data. Ms. Galvin determined that the prime rate during the relevant period ranged from 8.50% to 10.87%, to which she added a credit risk adjustment of 8.76%, yielding a prime rate with credit risk adjustment built in of 17.26% to 19.63%. These final amounts approximate a market borrowing rate a third party

was likely to demand for lending funds to LPI during 1991. The interest rates as described were applied to the outstanding balance of cash which Panavision had transferred or loaned to LPI, which on January 1, 1991, was $18,215,508.00. This balance was calculated based on cash transfers from Panavision in the amounts of $8,975,000.00 and $4,600,000.00 in 1989 and 1990, respectively, added to which was compounded interest on the balances based on adjusted market rates of 19.63% and 18.77%, respectively. The total arm's length compounded interest owed to Panavision from LPI for the period January 1, 1991 through May 31, 1991 was calculated to be $1.58 million. Ms. Galvin concluded that the transaction was not arm's length since LPI paid no part of the $1.58 million of interest to Panavision.

26. The only income earned by LPI during 1991 was interest and dividend income.

27. The parties stipulate that the following seven agreements existed concerning petitioner and were made a part of the hearing record:

a) Pledge Agreement dated October 13, 1987;

b) Pledge Agreement dated February 17, 1988;

c) Guaranty Agreement dated October 17, 1987;

d) modification of the Guaranty Agreement dated February 17, 1988;

e) Guaranty Agreement date February 17, 1988;

f) Collateral Agreement dated February 17, 1988; and

g) Cash Collateral Agreement dated February 17, 1988.

Additionally, a copy of petitioner's board meeting minutes concerning Panavision's participation in the reorganization of LPI was also made a part of the record.

28. Prior to the 1991 reorganization, LPI was considering filing for bankruptcy due to its difficulty paying creditors. The 1991 reorganization plan included negotiations with the debtors and creditors of Panavision and LPI. The successful completion of the debt restructuring was announced on June 10, 1991.

SUMMARY OF THE PARTIES' POSITIONS

29. Petitioner argues that the Division should not be permitted to eliminate taxpayers, in this case LPI and five other subsidiaries, from a combined group once the statute of limitations to assess tax for any member of the combined group has expired. Simply stated, since the statute of limitations had expired to assess additional tax on LPI and the five subsidiaries seeking to file on a combined basis, the Division should not be permitted to assess Panavision.

Petitioner maintains that LPI and Panavision meet the criteria for filing their New York franchise tax reports on a combined basis.

30. The Division argues that the statute of limitations for assessing Panavision on a separate company basis did not expire, and petitioner's reliance on ***Matter of Turbodyne Corporation*** (Tax Appeals Tribunal, July 3, 1996, ***confirmed Matter of Turbodyne Corp. v. Tax Appeals Tribunal***, 245 AD2d 976, 667 NYS2d 105, ***lv denied*** 91 NY2d 812, 671 NYS2d 1715) is misplaced.

Concerning combined reporting, the Division maintains that petitioner and the other corporations were not operating on a unitary basis, since the companies were not functionally integrated, there was no flow of value, there was no provision of substantial services provided to petitioner by LPI, and cash management services provided by LPI were nonexistent. Regarding distortion, the Division argues that without substantial intercorporate transactions between

petitioner and LPI, there was no presumption of distortion, leaving distortion for petitioner to prove, which it has failed to do.

CONCLUSIONS OF LAW

A. The first issue in this case presents the question whether the statute of limitations on assessment or refund must be open for each individual corporation seeking permission to be included in a combined franchise tax report for the Division to assess one of the corporations on the basis of a separate filing. There is no dispute as to the following facts: Panavision, LPI, Lee International Acquisitions, Colortran, Inc., Lee Colortran Holdings, Inc., Lee Lighting America, Ltd., and Lee America West Ltd., filed a combined report for tax year 1991 on or about December 15, 1992 (eleven and one-half months after the end of their respective calendar tax years), and made their request to file on a combined basis with the filing of that combined corporate return; at the time of such request, each corporate year was open for assessment; during a field audit of only Panavision, the company executed several consents to extend the statute of limitations, which extended the period of assessment for Panavision until April 30, 1998; the statute of limitations on assessment for Panavision was open for petitioner at the time of assessment (April 20, 1998), but was closed with respect to the other six entities; the assessment of Panavision is a reflection of tax due had petitioner filed on a separate basis; no other entity was assessed. The question at hand is whether the Division's action to assess petitioner on a separate basis was proper, effectively decombining the entities, when the period for assessing the other six corporations seeking combination with petitioner was closed.

Petitioner raises the statute of limitations as a defense to the assessment of Panavision and decombination of the corporate entities, citing ***Matter of Turbodyne (supra)***. Petitioner argues

that in accordance with ***Turbodyne***, the Division should not be permitted to eliminate a taxpayer member (i.e., LPI) from a combined group once the statute of limitations for any taxpayer member of the combined group has expired. The Division in response argues that the statute of limitations is an affirmative defense which, if not pleaded, is waived, and maintains that petitioner's reliance on ***Turbodyne*** is misplaced. Petitioner counters the Division's argument with its response that it is permitted to amend its pleadings to conform to the evidence of the case, and reaffirms its reliance upon ***Turbodyne*** to challenge what it believes is an improper change to the filing status of LPI.

B. Turning first to the procedural stance of an affirmative defense, although the exercise of an affirmative defense, such as an assertion of the statute of limitations, should be included in an initial pleading (here, the petition), it is permissible for petitioner to amend its pleading to conform to the evidence (Siegel, NY Prac § 223, [3rd ed]). The governing regulations of this body, the Tax Appeals Tribunal Rules of Practice and Procedure at 20 NYCRR 3000.4(d)(2)(i) permits issues not raised by the pleadings to be treated as though they have been properly raised when tried by express or implied consent of the parties. Furthermore, failure to amend does not affect the result of the trial of these issues.

In this case petitioner placed the Division on notice sometime prior to the hearing that the statute of limitations was an issue which concerned petitioner, since each representative acknowledged such fact as an issue in their opening statements on the first day of the hearing (Tr. pp.14, 16). Clearly there was a trial of this issue by express consent, and it is therefore treated as if it was raised in the initial petition (20 NYCRR 3000.4[d][2][i]), and is not waived.

C. Petitioner relies heavily on ***Turbodyne*** in support of its position that since the statutes of limitations to issue assessments for all the corporations in the proposed combined group were not

open, the assessment of Panavision should fail (presumably without consideration as to the merits of combination). The Division argues petitioner's reliance on ***Turbodyne*** is misplaced. I agree with the Division and find distinguishing facts between the two matters.

In ***Turbodyne,*** each of the corporations filed on a separate report basis, and petitioner therein did not request permission to file on a combined basis until after the audit had been undertaken. Because of the passage of time, the statute of limitations had closed for all of petitioner's affiliates, and petitioner therein was the only open-year corporation, resulting from the consents it had executed extending the statute of limitations. While its limitations period was open, but after the related corporations' limitations periods had closed, Turbodyne filed an amended combined report with those entities, which, if accepted, would have resulted in a refund to Turbodyne. In that case, there was no request for combination during the time when petitioner's affiliates' years remained open. The Tax Appeals Tribunal ruled that a corporation may not amend its Corporation Franchise Tax Report in order to file on a combined basis with affiliates when the limitations periods within which to assess tax or request a refund for the other corporations had closed. The Appellate Division confirmed stating:

> In other words, logic and fairness dictate that once the Statutes of Limitation have expired with respect to a member of the combined group, the Division should not be able to include the 'closed-year' corporation to generate an additional assessment for the remaining 'open-year' members of the group, and the open-year members of the group should not be permitted to revive the closed-year member to generate a refund ***Matter of Turbodyne v. Tax Appeals Tribunal***, 245 AD2d 976, 667 NYS2d 105, 107).

In this case, the request for combination was made while the periods of limitations for assessments for all the corporations in the proposed combined group remained open. The Division had extended the statute of limitations by consents as to Panavision alone, and issued an

assessment within the statute on the basis of 20 NYCRR former 6-2.4(b), which provided the Division with the authority to assess petitioner on a separate company basis (while the statute of limitations was still open) since petitioner had not filed a written request for permission to file on a combined basis within 30 days of the close of the tax year of the combining entities. In addition, Panavision alone was assessed; no other corporation was included in that assessment, and none of the other six entities was issued an assessment. Unlike ***Turbodyne***, the Division's assessment was in accordance with the preservation of its right to review the requested combination, and did not in any way prejudice the other corporations.

The Division properly assessed petitioner under the authority of 20 NYCRR former 6-2.4(b), since the combined franchise tax report was not filed until December 15, 1992, more than 30 days after the close of the tax year of the combining entities (***see, WWOR-TV, Inc. v. New York State Dept. of Taxation & Finance***, Sup. Ct., Albany Co., Keegan, J., June 24, 1992). 20 NYCRR former 6-2.4(b) merely gives the Division the rational basis to make the assessment, and although this action by the Division effectively decombined the seven entities, the Division is not attempting to deny combination solely on the procedural 30-day requirement, which it would not be permitted to do under these facts if the combination criteria is indeed met (***Matter of Autotote Limited,*** Tax Appeals Tribunal, April 12, 1990).

In summary, the Division is not prohibited by the statute of limitations from assessing Panavision when the assessment (of Panavision alone) was made during an open period of assessment for petitioner, and after the combination request was made during the same open period for all the entities involved.

D. Tax Law Article 9-A imposes a tax on foreign corporations doing business in New York on the basis of the business they generate in the State (Tax Law § 209[1]). In order to properly reflect that tax liability, Tax Law § 211(4) authorizes the Division to require or permit corporate taxpayers subject to New York State tax to file combined reports with other corporate taxpayers irrespective of whether such corporations are doing business in the State, where: the parent owns or controls substantially all of the stock of the subsidiary; the corporations are, in substance, part of a unitary business conducted by the entire group of corporations; and if, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income (***Matter of Campbell Sales Co. v. State Tax Commn.,*** 68 NY2d 617, 505 NYS2d 54, 54-55, ***cert denied*** 479 US 1088, 94 L Ed 2d 151; ***see also, Matter of Wurtlitzer Co. v. State Tax Commn.***, 35 NY2d 100, 358 NYS2d 762; ***Matter of Coleco Industries v. State Tax Commn.,*** 92 AD2d 1008, 461 NYS2d 462, ***affd*** 59 NY2d 994, 466 NYS2d 682; 20 NYCRR 6-2.3; 20 NYCRR 6-2.5[a]).

The Division's regulations, in effect for the tax year in issue, follow the case law and provide that the Division may require or allow the filing of combined reports where the three conditions of the regulations have been 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) an "other requirement" which has been referred to as the distortion of income test (20 NYCRR 6-2.3 [relating to taxpayers]; 20 NYCRR 6-2.5[a] [relating to foreign corporations]).

E. The parties have stipulated that the stock ownership requirement of 20 NYCRR 6-2.2 has been met, and the facts of this case support such stipulation.

F. The unitary business requirement is evaluated by the guidance set forth in 20 NYCRR 6-2.2(b), which provides as follows:

> 1. In deciding whether a corporation is part of a unitary business, the Tax Commission will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:
>
> i. manufacturing or acquiring goods or property or performing services for other corporations in the group; or
>
> ii. selling goods acquired from other corporations in the group; or
>
> iii. financing sales of other corporations in the group.
>
> 2. The Tax Commission, in deciding whether a corporation is part of a unitary business, will also consider whether the corporation is engaged in the same or related lines of business as the other corporations in the group, such as:
>
> i. manufacturing or selling similar products; or
>
> ii. performing similar services; or
>
> iii. performing services for the same customers.
>
> 3. Examples:
>
> * * *
>
> Example3: The taxpayer, a manufacturing corporation, forms a holding company which is also subject to tax. The holding company owns all of the manufacturing company's stock. The only activity of the parent-holding company is to receive dividends from the manufacturing corporation. The corporations are not conducting a unitary business.

The unitary business concept in Federal constitutional law developed in response to the states' authority to devise formulas to accurately assess a corporation's intrastate value or income, and to limit the states' authority to tax a corporation's value or income not attributable to

the taxing state (***Allied-Signal, Inc. v. Director, Div. of Taxation***, 504 US 768, 119 L Ed 2d 533 [1992]). The Tax Appeals Tribunal has applied the Supreme Court's unitary business standard to issues arising under Article 9-A of the Tax Law (***see, Matter of USV Pharmaceutical Corp.***, Tax Appeals Tribunal, July 16, 1992 [combination issue]; ***Matter of British Land [Maryland], Inc.***, Tax Appeals Tribunal, September 3, 1992 [allocation percentage issue arising under Tax Law § 210(8)]).

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

> The constitutional prerequisite to an acceptable finding of unitary business is a flow of value (***Container Corp. of Am. v. Franchise Tax Bd.***, 463 US 159, 178). The constitutional test focuses on functional integration, centralization of management and economies of scale (***Allied-Signal, Inc. v. Director, Div. of Taxation, supra***, 112 S Ct 2251, 2252, 2261). In ***Allied-Signal,*** the Supreme Court recently clarified the meaning and application of these factors by stating that these essentials could respectively be shown by: transactions not undertaken at arm's length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business (***Allied-Signal, Inc. v. Director, Div. of Taxation, supra***, 112 S Ct 2251, 2264). The ***Allied-Signal*** decision credits the decision in ***Containe***r as having identified these factors as evidence of a unitary business and cites to specific parts of the ***Container*** decision for each factor. The citations are instructive in understanding the factors and applying them to the instant facts.
>
> First, with respect to the non-arm's length transaction, the Court in ***Allied-Signal*** identified this as an element to prove functional integration and referred to that part of its ***Container*** decision where it noted that there was a flow of capital resources from ***Container*** to its subsidiaries through loans and loan guarantees, which were not shown to be at arm's length and which obviously resulted in a flow of value (***Allied-Signal, Inc. v. Director, Div. of Taxation, supra***, 112 S Ct 225, 2264, citing ***Container Corp. of Am. v. Franchise Tax Bd., supra***, at 180, n. 19). The ***Container*** decision also stated that a capital transaction can serve either an investment function or an operational function and concluded that Container's capital transaction served an operational function -- to ensure the

continued growth and profitability of the subsidiaries (***Container Corp. of Am. v. Franchise Tax Bd., supra***, at 180, n. 19).

G. Petitioner's argument that it should be permitted to file on a combined basis with six other entities centers around Panavision's relationship with one entity, LPI, its parent, in two major areas: cash management of Panavision's excess cash and management services provided by LPI to Panavision.

The first way that LPI claims to have provided significant services to Panavision and other subsidiaries is the cash management of moneys allegedly loaned from Panavision to LPI. LPI had incurred substantial debt when it purchased Panavision, restructured its existing debt and bought back the shares of Lee International, PLC in 1987. The parent company and its subsidiaries struggled with this debt for some four years, nearly filing for bankruptcy, until a massive reorganization was completed in June 1991. Virtually from the time LPI acquired Panavision, it was divesting Panavision of its daily cash in a manner described by petitioner as loans to LPI. In addition, LPI swept cash from Lee Colortran and Lee Lighting America, although the record is not clear as to whether this continued into 1991. When Mr. Scott first addressed questions about the sweeps, he admitted not knowing the actual mechanics of this activity. He did not believe the sweeps were daily and he seemed unsure whether the transaction was actually recorded as an intercompany payable and receivable. He was sure, however, that LPI got all the cash possible out of Panavision and any other company with excess cash, for the purpose of making its debt payments. His later testimony indicates that LPI invested the cash in short term securities with no reference to the debt payments. However, throughout the hearing it

was clear that LPI never had the original debt load under control and the only resolution to the problem was the complete reorganization of the group in 1991.

The cash sweeps involved the setting up of a zero balance account that would handle the transfer of funds. Panavision had no authority to limit the cash swept, but petitioner's management team understood that Panavision was part of an overall group that had enormous debt repayment for which it had become partly responsible. Mr. Phillips, Panavision's controller, claimed that Panavision benefitted from LPI's cash management, referring to the sweeps, by obtaining a marginally better rate of interest on invested funds than Panavision could have obtained on its own. No further evidence or testimony concerning this was provided, however. Given the financial status of LPI contrasted with Panavision's stability and success, it is difficult to fathom that LPI could have accomplished an investment task that Panavision could not have done on its own. In analyzing the significance of the cash management allegedly performed by LPI for Panavision, it is important to remember that Panavision was already a successful company, and it was the cash from Panavision that was primary in the repayment of debt undertaken by LPI. Furthermore, the testimony provided on the issue of repayment of the loans was quite evasive. Essentially, Mr. Scott and Mr. Phillips stated that Panavision may have anticipated repayment of the loans, but not necessarily in a pure form, both referring to the fact that it was more likely to be part and parcel with the reorganization of the companies. Clearly, however, Panavision did not have the ability to demand repayment, and no terms were established evidencing the debt.

H. A flow of value is said to be a prerequisite to a constitutionally acceptable finding of a unitary business (***Container Corporation of America v. Franchise Tax Board,*** 463 US 159 77

L Ed 2d 545, 561, ***rehearing denied*** 464 US 909, 78 L Ed 2d 248). In a broader sense, the Supreme Court in ***Container*** stated that when viewing a unitary business from a functional perspective, there should be some sharing or exchange of value not capable of precise identification or measurement, beyond the mere flow of funds arising out of passive investment or a distinct business operation (***id*** at 166, 77 L Ed 2d at 554). The flow of capital resources in this case was from Panavision to LPI, subsidiary to grandparent, opposite the flow of resources in ***Container***. One could argue that the alleged loan and loan guarantee extended by Panavision's pledge of its stock as part of the collateral for the Lee group debt constituted a flow of value, which was not at arm's length (since no interest was charged for the loan), thereby leading to the conclusion that the functional integration of a unitary business analysis has been met (***id***). But I believe a different analysis is more suited to these facts. The key is in the classification of the transactions. As ***Container*** expressed quite clearly, a capital transaction can serve either as an investment function, or an operational function (***id*** at 180, n.19; 77 L Ed 2d at 562. n.19). In this case, LPI made an investment when it purchased Panavision. When LPI performed cash sweeps, it was to obtain the fruits of that investment, not as part of its operational function, which was defined by testimony and documents as a holding company and funding vehicle. The only funding done by LPI was repayment of the Lee group debt, related only indirectly to some of the group's subsidiaries. Viewed from Panavision's position, the transfer of funds was only as a result of the investment function, not as part of its operational function, the business of camera equipment design, manufacture and leasing. Panavision, in this case the "lender," did not have any control over the existence of the loans or the use of the funds.

It certainly could not be sure that such funds were utilized to support the growth and profitability of the company.

In the circumstances of this case, the flow of funds functioned more closely as a constructive dividend than a loan. This can be seen in the facts that Panavision had no ability to demand repayment or exert any control over the funds; the transaction was absent any agreement concerning repayment of the balance; none of the funds were actually repaid; no interest was charged on the balance; and no entry was provided in Panavision's financial information section of Form AU-2.1 (the request for permission to file on a combined basis) on the line designated for "Loans to stockholders." Although Panavision may not have had the freedom to issue dividends without consequences, the fact that this transaction is reclassified as a dividend based upon substance over form does not invalidate the conclusion that the transfers of funds amounted to dividends, for which no interest charge should be imputed. LPI's concern was simply to stay afloat, and that goal had nothing to do with any interplay between parent and subsidiaries to foster corporate expansion or profitability by a transfer of funds on a non-arm's length basis that would lead to a conclusion that LPI and Panavision were functionally integrated (***see, Container Corp. of Am. v. Franchise Tax Bd.***, ***supra***). If the only function of the parent holding company is to receive dividends from its subsidiary, it follows that the corporations are not conducting a unitary business (20 NYCRR 6-2.2[b][3], Ex. 3).

Although the testimony by Scott and Phillips sometimes referred to the cash sweeps as transfers and other times specifically as loans, the facts of this case do not support a clear finding that bonafide loans existed. Reliance on what petitioner classified as loans between Panavision and LPI does not serve to characterize these companies as functionally integrated enterprises,

which would serve to support the finding of a unitary business relationship. Additionally, the sweeps by LPI were not cash management services which may have otherwise established an exchange of value between the two companies.

The second way in which petitioner attempts to show it is part of a unitary business is by virtue of LPI's management role vis a vis Panavision, and to some small degree, the other affiliates. Petitioner attempts to portray the management relationship between LPI and Panavision as seamless. Petitioner focuses on the role Mr. Scott played as officer and director of LPI, and the services he performed concerning management of expenditures and the hiring of upper level employees. Mr. Scott had frequent contact by telephone with John Farrand, president of Panavision, though he lived in New York and was based in London. In one circumstance, when General Camera was delinquent in its remittances to Panavision, Mr. Scott stepped in to take charge of negotiating new payment terms. Mr. Scott was very involved in negotiations with the creditors of LPI concerning the debt the group had undertaken. Clearly he contributed in various management areas, including review of policies and debt management, as did McGonigle, Buchner and Goldner in other ways (***see,*** Finding of Fact "13"). However, the integration of management did not rise nearly to the level of seamless management. Clearly, there were high level managers of LPI who were in a position to comment upon and exert discretion over the activities of any of the subsidiaries, including Panavision. There is no doubt about the fact that some management oversight was present and perhaps necessary and even welcome. But Panavision had its own management team that Mr. Scott commented favorably upon. Mr. Scott praised the superior job done by John Farrand in running Panavision and indicated that he left the running of Panavision to him. Mr. Scott himself stated that he was

recruited to head up LPI for the future purpose of taking Panavision public, which eventually happened in 1996. Between 1988 and 1991, his primary role was to rationalize the assets, i.e., sell off the businesses in the group that he did not choose to keep, and make sure the ones retained were properly managed. During 1991, Mr. Scott was a key person in the negotiations with Citicorp and the banking group concerning the company's debt and the proposed reorganization. To the extent the debt affected the entire company group, Mr. Scott's efforts benefitted the entire group. However, there is no mention of LPI's involvement with what was at the heart of Panavision's success, i.e., the design and manufacture of its camera systems and equipment. LPI performed no management function in the manufacture, design or leasing of the equipment. LPI did not become involved with Panavision's distributors, customer base or customer service. There is no mention that LPI exercised any management discretion over Panavision's research and development of new products, obsolete items, new technology or new geographics to serve. There was no overall management strategy established by the facts. The employee benefit plan in place during 1991 for the executives of LPI, and managed and administered by LPI, did not include Panavision and the other subsidiaries. Such a plan broadly covered all employee benefit and administrative policies, medical and dental plans, vacations and sick day policies, and pension and 401(k) plans. ***Container*** describes centralization of management, a component of a unitary enterprise, as a management role by the parent which is grounded in its own operational expertise and strategy. LPI can claim to have been exercising management decisions on behalf of Panavision. But clearly the decisions were more closely aligned with the type of oversight that any parent gives to an investment in a subsidiary, with respect to capital structure, major debt, and dividends (***F.W. Woolworth Co. V. Taxation and***

Revenue Department of the State of New Mexico, 458 US 354, 369, 73 L Ed 2d 819, 830). There were no business guidelines or strategies developed by LPI for its subsidiaries, no technical assistance provided to further the business operations of the subsidiaries, no role performed by LPI that could be said to emanate from LPI's operational expertise, since its primary focus was management of the Lee group debt (***see, Container Corp. of Am. v. Franchise Tax Bd.***, ***supra***). Despite some management contributions from the executives of LPI, the type ordinarily provided by a parent corporation to a subsidiary, centralized or seamless management did not exist.

The final element of a unitary business is economies of scale. ***Container*** described this in the following way:

> When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use-either through economies of scale or through operational integration or sharing of expertise-of the parent's existing business-related resources (***id.*** at 178, 77 L Ed 2d at 561).

With the exception of the Orlando location relationship described between Lee Lighting America and Panavision, no examples of economies of scale were established by the facts of this case.

I am not convinced that LPI and Panavision should be permitted to file on a combined basis, had LPI's and Panavision's been the only corporations' activities subject to review. The management services provided by LPI were an overview at best, with more significant interaction at specific points in time, or to address key issues. They are not the type of centralized management discussed in the context of determining that the companies operated in a unitary mode (***see, id.; Exxon Corporation v. Wisconsin Department of Revenue***, 447 US 207,

65 L Ed 2d 66). Additionally, the classification of LPI's cash sweeps as management services, especially to Panavision is absurd. The transfers of funds were not loans which resulted in an exchange of value. LPI seized the opportunity to acquire Panavision, a successful company with a niche in the camera production market, and a significant amount of excess cash. Aside from the fact that LPI desired to take Panavision public, it drained Panavision of its resources to service debt the Lee group had undertaken. I would suspect this did not leave Panavision in a better position between 1988 and 1991 than it may have been in without LPI's ownership. Certainly, the cash sweep left Panavision, at the very least, in a position where the company could do less research and development of new products or leasing opportunities without excess working capital, with no real expectation as to repayment. In summary, the relationship between LPI and Panavision was not a unitary one as between themselves, and certainly does not establish a unitary relationship for the seven companies subject to proposed combination.

LPI and Panavision were not the only two companies subject to the proposed combination, and this fact was significantly overlooked by petitioner. With regard to establishing the existence of a unitary relationship, the regulations which determine whether a corporation is part of a unitary business mandate consideration of the activities of a particular corporation in relationship to *the other corporations in the combined group* (20 NYCRR 6-2.2[b]). But there is virtually no discussion about the relationship of Panavision to the five other entities, or those entities to each other or LPI, with the exception of a general statement regarding the parent's involvement with all of its subsidiaries. Panavision did not utilize any of the other six entities in the process of manufacturing the equipment and systems; Panavision did not use of any of these companies to act as agents in any step of the leasing process, including

the sales force; Panavision had its own well-qualified management team and sales strategy; it did not perform services for any of the other corporations; and the company did not sell goods acquired from another related corporation. The relationship between Panavision and Lee International Acquisitions, a holding company, extended only to the fact that Lee International Acquisitions held the shares of Panavision (***see,*** Footnote 3). Lee Colortran Holdings held the stock of Lee Colortran, and had no independent relationship with Panavision. Lee Colortran and Lee Lighting America were involved in the manufacture and distribution of lighting equipment for related motion picture businesses. Panavision and Lee Lighting America shared rental space in Orlando, Florida where they operated under one store front, leased by Lee Lighting America. Panavision paid for a proportion of the lease, but the terms were not made a part of the record. Each employed seven or eight people in that location. Panavision handled the administration of accounts payable for the Orlando store for both companies, without a charge back to Lee Lighting America. There was no information provided as to the success of this business location for either of the companies, in what relation the sales or leasing from this site was relative to total overall sales or in what way the presence of the other company enhanced their overall profitability. However, considering the fact that Panavision employed approximately 400 people during 1991, the Florida operation, relative to the number of employees is suggested to be rather small. Although it appears as though Panavision, Lee Colortran and Lee Lighting America may have been manufacturing similar product lines, engaged in related lines of businesses or performing services for the same customers, petitioner did not establish this type of interaction by the facts of this case with the entities other than Lee Lighting America. What interaction was

detailed with respect to Lee Lighting America was not proven to be significant in the overall picture by the facts herein.

Lastly, Panavision did not have an active business relationship with Lee America West. Although legally incorporated in 1991, Lee America West did not have active business operations during 1991. Thus, no interaction of business activities was established between Lee America West and any of the other six entities.

Turning to the business activities of Lee Lighting America, the company served as the largest supplier in Europe of rental lighting equipment to the motion picture and television industries. It was established that the company shared the Orlando rental store front with Panavision, where Lee Lighting America employed seven people. Other than the facts that Lee Lighting America and Panavision intended to capitalize on cross-selling opportunities, and shared some administrative services, no additional information was provided as to their interaction. Clearly, their businesses were far from intertwined. Furthermore, the *potential* to operate a company as part of a unitary business is not dispositive when looking at the underlying economic realities of a unitary business (***F.W. Woolworth v. Taxation and Revenue Dept., supra***, citing ***ASARCO Inc. v. Idaho State Tax Commn***, 458 US 307, 73 L Ed 2d 787). Lee Lighting America owned the shares of Lee America West, a company which was inactive during 1991. Certainly, no active relationship could be discerned from this association. There was no evidence that Lee Lighting America had any business activities with Lee International Acquisitions, Lee Colortran Holdings, or Lee Colortran. Lee International Acquisitions was the holding company for the stock of Lee Colortran Holdings and Panavision. Although the purpose and function of each of the holding companies was described as "funding vehicles," neither Lee

International Acquisitions nor Lee Colortran Holdings had employees in 1991 and each had only interest or dividend income as its revenue stream. There was no evidence as to the functions performed by these alleged funding vehicles.

In summary, the companies subject to proposed combination did not establish that they are part of a unitary relationship with functional integration, centralized management and economies of scale (***Container Corp. of Am. v. Franchise Tax Bd.***, ***supra)***. Accordingly, the Division properly assessed Panavision on a separate filing basis.

I. Assuming *arguendo* that a unitary business relationship were found, a determination must be made whether reporting on a separate basis would result in distortion. The final criteria for the combined filing, the distortion factor, arises in the situation where 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 regulations presume such distortion when the taxpayer reports on a separate basis "*if there are substantial intercorporate transactions among the corporations*" (20 NYCRR 6-2.3[a]; emphasis added).

The presumption of distortion created by substantial intercorporate transactions may be rebutted by showing that the transactions which give rise to the presumption are arm's length (***Matter of Standard Mfg. Co.,*** Tax Appeals Tribunal, February 6, 1992). Internal Revenue Code § 482 adjustments may be used to show arm's-length pricing between related companies where a Federal audit has resulted in adjustments (***Matter of USV Pharm. Corp.,*** Tax Appeals Tribunal, July 16, 1992; ***Matter of Standard Mfg. Co., supra***). In the absence of section 482 adjustments, it is appropriate to apply the principles of section 482 since that section shares a

similar purpose with Tax Law § 211(4), i.e., the proper reflection of income (***Matter of USV Pharm. Corp., supra; Matter of Sears, Roebuck & Co.***, Tax Appeals Tribunal, April 28, 1994).

Where a taxpayer fails to meet the presumption of distortion because it does not have substantial intercorporate transactions "and if the filing of a report on a separate basis nevertheless results in a distortion of such taxpayer activities in New York State, then the Division will permit or require the filing of a combined report" (20 NYCRR 6-2.3[d]).

In this case, petitioner has conceded that substantial intercorporate transactions do not exist between itself and LPI. No assertion has been made that substantial intercorporate transactions exist among any of the seven entities of the proposed combination. Thus, petitioner must prove that if it files on a separate basis, distortion will result. The distortion which petitioner attempted to establish centered around two sets of transactions, which are outlined in detail in the expert's report (***see,*** Finding of Facts "21 - 25"). Distortion may be shown by the absence of arm's length pricing (***see, Matter of Mohasco Corporation***, Tax Appeals Tribunal, November 10, 1994) This is precisely what Ms. Galvin attempted to do with the Transfer Pricing Report introduced into evidence. However, certain flaws in the available information, and perhaps in part, her methodology, lead the results askew.

J. Even if one concludes that a unitary relationship existed among the seven entities, any semblance of centralized management was a very weak link. As to the assessment of management services, there is a very significant assumption that Ms. Galvin makes without the support I believe appropriate, i.e., that the Benefit Test is passed. I am convinced that many of the services under review were a duplication of services performed by Panavision by its own management team, a team which led Panavision successfully. Unfortunately, the conclusion

requires a look at what was not brought to the hearing and was not provided to Ms. Galvin for the preparation of her report. Panavision limited the intercompany transactions that were subject to Ms. Galvin's review. Perhaps it can be argued that given the cost of such professional services one must draw the line somewhere. But without numerically quantifying each and every intercompany transaction that proved distortion, she could have been permitted to review them in detail from a discussion standpoint. This was not done. In addition, Ms. Galvin's testimony distinctly left me with the impression that, despite the fact that she reviewed stacks of documents, she may have been given only what the company in fact wanted her to see. Concerning the choice of people to interview, although John Farrand was still with the company and in the best position to discuss how Panavision's management functioned, he was not made available to Ms. Galvin. These facts substantially diminish the reliability of her report, despite her qualifications as an expert in transfer pricing.

Next, concerning the management services provided by LPI to Panavision, Ms. Galvin interviewed Scott, Phillips and Marcketta. Scott first testified that he was not interviewed during the preparation of the report because he believed the expert was aware that he could not provide any "real information." Then he testified that he did not recall if he was interviewed by the expert, but that he knew she interviewed people who were more intimately involved with the subject of the report than he was. Later in the hearing, on the same day, he recalled a meeting in May 1999 with Ms. Galvin, where they discussed his relationship with Panavision and LPI.

The transfer pricing study submitted into evidence in support of petitioner's position indicated a percentage of time spent by McGonigle, Goldner, Buchner and Dignam that concerned stewardship services. Although Scott previously testified that he could not state what

each of these gentlemen did, since they did not answer to him, when looking at the transfer study, he indicated that he thought the stewardship percentages looked accurate. He said so despite the fact that Mr. Scott did not review the Transfer Pricing Report after its preparation. Given the conflicts in this portion of his testimony, I do not deem it a reliable basis for the assessment of management services, and more narrowly, the calculation of stewardship expenses.

Phillips, employed by Panavision, provided testimony at the hearing. He was not generally in a position to know in great detail in what capacity each of the LPI executives was acting. Furthermore, he was not in a top management position in 1991, as controller, and his actions were reported up the corporate ladder. There is some doubt as to how completely he could assess LPI's management services to Panavision.

Marcketta did not testify, and his contribution to the report in the context of management services provided by LPI is not set forth in any detail.

LPI was stated to be a holding company and funding vehicle, not a management company. I believe it is overreaching to allocate all of LPI's expenses to the computation of management services, rather than expenses which relate directly to services provided, such as a portion of salaries, less stewardship.

Given Mr. Scott's position, having no stewardship percentage attributed to him is an error given his position of overseeing the subsidiaries.

Lastly, Ms. Galvin does not allocate management fees to all the subsidiaries in the Lee group, despite the fact that Scott purportedly oversaw all the companies. No explanation is provided as to why 16 of approximately 30 subsidiaries were selected for allocation in the report.

In summary, Panavision has not established that an arm's length charge should have been computed, without which distortion would occur if filing on a separate basis were to take place. At the very least, the methodology contains the flaws as noted, and fails to conclusively establish that distortion would occur if petitioner filed on a separate basis.

K. Petitioner attempts to show that filing on a separate basis will result in distortion since no interest was charged by Panavision to LPI on the loans it made to LPI. For petitioner to successfully prove this, one must first accept the fact that the cash transfers were indeed loans. I have rejected this conclusion in favor of a finding that the cash transfers did not constitute bonafide loans (***see,*** Conclusion of Law "H"), but rather were more appropriately characterized as constructive dividends. The Division correctly points out that interest should not be imputed unless there is bonafide indebtedness between members of the controlled group (Treas Reg § 1-482-2[a][ii][A]), and alleged indebtedness does not qualify as bonafide indebtedness (Treas Reg § 1-482-2[a][ii][B]). Likewise, if alleged indebtedness is a distribution with respect to a corporation's shares, there is no interest adjustment pursuant to IRC § 482. Accordingly, petitioner has failed to prove that filing on a separate basis would result in distortion of income.

L. If, however, a determination is made that petitioner made bonafide loans to LPI for which interest should have been charged to avoid distortion, the calculation by Ms. Galvin, in her expert capacity, of interest that should have been charged, is accepted as valid (***see,*** Finding of Fact "25").

M. The Division imposed penalties pursuant to Tax Law § 1085(k), for a substantial understatement of tax for the year 1991. The Division may waive all or any part of the addition

to tax on a showing by petitioner that there was reasonable cause for the understatement and that the taxpayer acted in good faith (Tax Law § 1085[k]).

Petitioner did not offer sufficient proof to meet the reasonable cause standard. When petitioner requested permission to file, it stated that the companies had operated a unitary business since 1988. However, no prior request was made to file in combined form. No explanation was provided as to why combination was not proposed for prior years, or what facts differed. One fact was clear about 1991: LPI and various other subsidiaries had substantial business losses and net operating loss carry forwards that could offset significant income earned by Panavision. Although the proposed combination may have obtained favorable tax results which petitioner is permitted to seek, a slanting of the facts that did exist is not permissible. In addition, petitioner's posture toward Ms. Galvin's fact finding and the conflicting portions of testimony all contribute to my opinion that Panavision has not shown the good faith necessary to have penalties waived.

N. The petition of Panavision, Inc. is hereby denied and the Notice of Deficiency dated April 20, 1998 is sustained.

DATED: Troy, New York
July 13, 2000

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE