STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CS INTEGRATED, LLC	:	DETERMINATION DTA NO. 817548
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1993 through 1997.	:	

Petitioner, CS Integrated, LLC, 701 Martinsville Road, P.O. Box 840, Liberty Corner, New Jersey 07938, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1993 through 1997.

A hearing was begun before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on October 24, 2000 at 10:30 A.M., and continued to completion on March 22, 2001, with briefs to be submitted by December 7, 2001, which date began the six-month period for the issuance of this determination. Petitioner appeared by Edward M. Griffin, Jr., Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Clifford M. Peterson, Esq., of counsel).

ISSUES

I. Whether petitioner was the true owner and seller of certain inventory situated in New York such that the value of the inventory and receipts from sale of the inventory were properly included in petitioner's calculation of its business allocation percentage.

II. Whether, if petitioner was the owner of that inventory, receipts from the sale of the inventory should be included in petitioner's calculation of business receipts for purposes of determining petitioner's business allocation percentage pursuant to 20 NYCRR 4-4.1(a).

III. Whether the Division of Taxation properly imposed a substantial underpayment of tax penalty for the years 1993 through 1997, and, if so, whether penalties should be abated for reasonable cause shown.

FINDINGS OF FACT

1. Petitioner, CS Integrated, LLC, and the Division of Taxation ("Division") entered into a stipulation of facts which has been substantially incorporated into these findings of fact.

2. Petitioner is a limited liability company organized under the laws of the State of Delaware. Its principal office is located in New Jersey.

3. On April 24, 1997, Christian Salvesen, Inc., ("CSI") was merged out of existence into petitioner.

4. During the tax years in issue, 1993 through 1997, CSI was primarily engaged in providing warehousing, refrigeration and cold storage services to the food industry. CSI would provide storage for a client's products and distribute those products to the client as needed. The distribution point was one of CSI's warehouses. The majority of CSI's business was conducted outside of New York State.

5. On June 13, 1989, CSI entered into an agreement (the "distributor services agreement") to provide warehousing and distribution services to one of its clients ("Company A"), a retail supermarket chain. At the time, CSI had no facilities in New York State. Pursuant to the agreement, CSI constructed a warehouse in Chester, New York. All of CSI's activities in Chester, New York were performed exclusively for Company A. Until 1991, CSI's activities for

Company A were restricted to the performance of refrigeration, cold storage and related services under the terms of the distributor services agreement.

6. At the time the distributor services agreement was entered into, Company A was experiencing substantial financial difficulties, and it continued to struggle financially after executing the agreement. Most of its cash was tied up in inventory and it was experiencing a cash flow problem. Company A approached CSI asking it to provide a loan to the company to finance Company A's inventory purchases.

7. CSI was reluctant to enter into a straight loan agreement. It did not want the assets of Company A, specifically the inventory which CSI was being asked to finance, to become available to all other creditors in the event of a Company A bankruptcy. To protect its interests, CSI negotiated an agreement (the "supplemental agreement") by which it would purchase the inventory of Company A located in the Chester warehouse and sell it back to Company A at cost plus a carrying charge. This arrangement was unique as CSI did not have such arrangements with any other warehouse customers.

8. The supplemental agreement between CSI and Company A, dated February 5, 1991, provided, in pertinent part, as follows:

> This letter will set forth our agreement regarding the distributor services to be provided by Christian Salvesen, Inc. ("CSI") to Company A:
>
> 1. CSI's Initial Purchase
>
> As of today, CSI hereby purchases and [Company A] hereby sells the frozen food and ice cream inventory currently located at the CSI Chester, New York warehouse facility and more particularly described in schedule A attached hereto exclusive of products bearing any [Company A] tradename [sic] or trademark ("[Company A] Brand Products") (the "Inventory"). The purchase price paid by CSI for the Inventory is $3,560,212.52, which amount represents the fair market value of such Inventory to [Company A] as also shown on Schedule A. Receipt of the purchase price is hereby acknowledged by [Company A]. This

Agreement shall constitute a bill of sale of the Inventory from [Company A] to CSI . . . .

* * *

2. CSI as [Company A] Exclusive Regional Distributor

[Company A] hereby agrees that CSI shall be [Company A's] exclusive regional distributor with respect to the types (not necessarily the brands) of products included in the Inventory as well as the types of products historically warehoused in CSI's Chester, New York facility for the benefit of [Company A]. Specifically, to the extent, from the date hereof throughout the term of this Agreement, [Company A] purchases any product of such type for ultimate sale within the New York Region (the "Region"), it shall purchase such products from CSI regardless of the availability (at equal or lower prices) of the same or similar products from competitors of CSI.

3. [Company A] Purchasing Assistance and Inventory Control

[Company A] agrees to purchase products at the request of CSI and immediately to resell to CSI at invoiced cost such products; provided the products are to be purchased from companies with which [Company A] will be placing an order within three months following CSI's request. . . . [Company A] agrees to provide, without any additional charge, inventory control assistance in the same manner and kind as has historically been provided by [Company A] at CSI's Chester, New York facility. . . .

* * *

4. CSI Agreement to Accommodate [Company A] Stocking Requirements

Subject to the provisions of this paragraph, CSI shall stock products in its inventory in accordance with advice and requests from [Company A] delivered from time to time. CSI will not be obligated to honor [Company A's] advice and requests to the extent that:

(a) the aggregate cost of the inventory (inclusive of the initial purchase pursuant to paragraph 1 of this Agreement plus additional purchases for that facility less amounts sold from that facility by CSI) would exceed CSI's then current budget levels. (CSI's current maximum inventory-carrying amount is $4.5 million);

* * *

8. Miscellaneous

A. Nothing in this Agreement shall be deemed to restrict the ability of CSI to sell any of the inventory or other products purchased from [Company A] to parties other than [Company A]. It is understood, however that [Company A] shall have priority as to availability of the Distribution Inventory.

* * *

C. [Company A] agrees to indemnify CSI for any liability (other than liability arising as a direct result of the negligence or willful misconduct of CSI) and for any and all liability or expenses, including without limitation expenses incurred in defending actual or threatened claims and litigation, in connection with the sale of defective or allegedly defective products.

9. The initial cap of $4.5 million on the cost of inventory was later increased to $5.35 million. For the initial and subsequent inventory purchases, CSI paid Company A directly, not Company A's suppliers.

10. By a second supplemental agreement dated June 24, 1997, Company A and CSI confirmed their mutual understanding that on termination of their relationship, Company A would pay to CSI "an amount equal to the consideration previously paid by CSI to Company A with respect to any remaining inventory . . . stored by CSI at any of its facilities."

11. Charges under the agreement were computed by CSI on a daily basis. If the dollar amount of product purchased from Company A exceeded the dollar amount of product sold to Company A on a given day, and the net increase was under the cap, CSI would owe Company A the amount of the net increase. If there was a net decrease in the amount of inventory, and the inventory was under the cap, Company A would owe the amount of the net decrease to CSI. An interest rate equal to prime plus 2.5 percent would be applied to the value of the ending

inventory on that day.[1] This amount would be divided by 365 to reach that day's carrying charge. Cash settlement of the daily charges was done on a weekly basis. CSI's purchases were never allowed to exceed the agreed upon cap.

12. The February 5, 1991 supplemental agreement between CSI and Company A supplemented, but did not replace, the June 13, 1989 distributor services agreement. During the tax years 1993 through 1997 CSI continued to charge Company A for warehousing, refrigeration, storage and handling of the inventory located at CSI's Chester, New York warehouse.

13. CSI filed New York State corporation franchise tax returns for the years 1993 through 1997. In calculating its receipts factor for business allocation purposes, CSI did not include receipts from the sale of inventory to Company A under the terms of the 1991 supplemental agreement. In addition, CSI did not include the inventory purchased from Company A in its property factor. CSI included payments made by Company A under the warehousing agreement and the amount of the carrying charges received from Company A in its receipts factor as New York receipts.

14. In each of its corporation franchise tax returns for the years 1994 through 1997, CSI included the following statement:

> The taxpayer has undertaken an inventory financing arrangement with an unrelated party. Accordingly, the taxpayer has only included the interest income (financing) in the receipts factor or other business receipts in New York State. The taxpayer is currently in the process of petitioning New York State for discretionary adjustment pursuant to the Regulations. The financing arrangement

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[1] The calculation of the daily rate using a value of prime plus 2.5 percent was established by the testimony of Anthony Cossentino, Senior Vice President and Chief Financial Officer of CS Integrated. This value is consistent with the calculation of the carrying charge of 12 cents per case as agreed to in paragraph 5 of the supplemental agreement. A prime rate of 9.5 percent plus 2.5 percent equals 12 percent. Twelve percent applied to the average inventory balance of $4.5 million as agreed to by the parties equals $540,000.00. This amount divided by average annual volume of cases shipped (4,160,000) equals .1298, approximately 12 cents per case.

> is unique and particular to New York. Actual business activities have properly included in the receipts factor as "Services Performed: and other business receipts.

15. In January 1995, Company A filed a petition for Chapter 11 protection from creditors in U.S. Bankruptcy Court. Later, in 1995, Company A emerged from bankruptcy.

16. In January 1996, the Division began an audit of petitioner's books and records for the years 1993 through 1997. At the initial pre-audit conference held on June 10, 1996, petitioner's representative informed the auditor that petitioner was then involved in a proceeding before an Administrative Law Judge in the Division of Tax Appeals (the "prior proceeding"). The auditor was provided with a copy of the 14-page reply brief filed by the petitioner in the prior proceeding. The issues raised in that proceeding related to petitioner's calculation of the receipts and property factors on the returns being audited.

17. As pertinent here, the reply brief provided to the auditor revealed that petitioner had filed a letter with the Division requesting a discretionary adjustment to petitioner's business allocation percentage for New York State corporation franchise tax purposes. This request was based on petitioner's contention that neither its sales of inventory to Company A nor the value of inventory covered by the agreement with Company A should be included in the calculation of petitioner's business allocation percentage. The Division denied petitioner's request for an adjustment. Petitioner then filed a claim for refund of the corporation franchise taxes paid for 1991 and 1992. It based its claim for refund on its claim that inclusion of the Company A receipts and property in its business allocation percentage resulted in distortion of its New York income. All of this information, along with petitioner's arguments before the Administrative Law Judge, were provided in the reply brief.

18. The auditor's handwritten audit log reveals that the Division took little action on the instant audit until the Administrative Law Judge determination was issued on October 31, 1996. The Administrative Law Judge decided all issues in favor of the Division and denied the petition.

19. The field audit then proceeded. Among other documents, the auditor reviewed petitioner's audited financial statements for two of the years at issue and petitioner's Federal income tax returns. The inventory held in CSI's Chester warehouse was shown in the audited financial statements as being owned by CSI. Sales of inventory made by CSI to Company A were included in CSI's sales on its income statement. The same sales were reported on CSI's Federal income tax returns. Based on these documents, the auditor determined that the receipts from sales to Company A and the value of the inventory held for sale in the Chester warehouse should be included in the calculation of petitioner's business allocation percentages for each of the audit years.

20. The Division adjusted petitioner's business allocation percentage for the audit years by including in its receipts and property factors, respectively, the gross sales and inventory values arising from the agreement with Company A. The Division then recomputed petitioner's corporation franchise tax liability and metropolitan transportation district surcharge using the higher business allocation percentage. The Division also imposed penalties for substantial understatement of tax due for each of the periods under audit.

21. The Division issued to petitioner a Notice of Deficiency, dated November 12, 1999, asserting deficiencies of corporation franchise tax and metropolitan transportation district surcharge totaling $2,406,055.00 for the fiscal years ending March 31, 1993 through April 24, 1997. For the same period, the Division asserted interest of $832,176.17 and penalty of

$241,518.90. Additional payments of $652,894.00 were applied to the balances due for the 1993 fiscal year. The total balance due as shown on the Notice of Deficiency is $2,826,856.07.

22. Petitioner timely filed amended returns for the final audit period which were audited by the Division after the issuance of the Notice of Deficiency. After audit of those returns, the Division and petitioner entered into a stipulation of facts setting forth the corrected audited amounts of additional tax, penalties, refunds and interest due for the audit period as follows:

Period Ending	Tax	Amount Due	Penalty	Interest	Total Due
03/31/93	Franchise	256,917.00	25,691.00	246,712.00	529,320.00
03/31/93	MCTD	37,979.00	3,797.00	38,701.00	80,477.00
03/31/94	Franchise	249,657.00	24,965.00	202,111.00	476,733.00
03/31/94	MCTD	17,330.00	1,733.00	14,257.00	33,320.00
03/31/95	Franchise	227,914.00	22,791.00	145,768.00	396,473.00
03/31/95	MCTD	12,077.00	1,207.00	8,246.00	21,530.00
03/31/96	Franchise	186,888.00	18,688.00	95,593.00	301,169.00
03/31/96	MCTD	9,807.00	980.00	5,016.00	15,803.00
03/31/97	Franchise	85,388.00	8,538.00	30,780.00	124,706.00
03/31/97	MCTD	4,146.00	-0-	1,495.00	5,641.00
04/24/97	Franchise	525,472.00	52,547.00	194,900.00	772,919.00
04/24/97	MCTD	29,014.00	2,901.00	10,761.00	42,676.00
04/25/97	Franchise	-581,901.00	-0-	-116,430.00	-698,331.00
04/25/97	MCTD	-70,993.00	-0-	-14,205.00	-85,198.00

23. In the fall of 2000, Company A filed a second bankruptcy petition that led to the liquidation of most of its assets. Until January 2001, petitioner continued to do business with Company A in an attempt to reduce inventory and petitioner's losses associated with the financing of that inventory. Petitioner stopped doing business with Company A as of

January 15, 2001. Petitioner filed a claim against Company A for repurchase of the existing inventory. It was ordered by the bankruptcy court to mitigate Company A's damages by reducing the inventory held by petitioner. Petitioner sought out potential purchasers for the inventory, primarily odd lot buyers who have purchased the inventory for 70 to 80 cents on the dollar.

24. Petitioner submitted 12 proposed findings of fact. All of them have been substantially incorporated into this determination with one amendment. Petitioner consistently refers to the agreement between CSI and Company A as an "inventory financing agreement." As the agreement does not refer to itself as such, that language has not been used in this determination.

SUMMARY OF THE PARTIES' POSITIONS

25. It is petitioner's position that for franchise tax purposes CSI was not the owner of the food products inventory it received under the terms of the supplemental agreement with Company A. It views CSI as a bailee for hire providing financing and warehousing services to Company A. It argues that the inventory transactions between CSI and Company A should be viewed as: (1) a series of loans made by CSI to Company A, collateralized by Company A's transfer of title to the inventory to CSI; (2) a series of loan payments by Company A to CSI, together with a release of collateral by CSI to Company A. Petitioner points to the following factors as evidence that it had none of the usual attributes of ownership of the inventory:

(a) Company A determined which products would be purchased. Those products were shipped to the CSI distribution center, but CSI had no control over what items were purchased, the only exception being the restriction on purchases of Company A brand name products. Company A retained all inventory control functions without any charge to CSI, just as it had done in the past with respect to inventory purchased directly by Company A. These terms,

petitioner argues, are inconsistent with true ownership by CSI but consistent with a loan transaction collateralized by the inventory.

(b) CSI did not have a right to freely dispose of the property. CSI was required to sell the inventory purchased from Company A back to Company A at cost. Although CSI was allowed to sell the inventory to third parties, Company A was given priority with respect to the purchase of products. In addition, CSI, which was not a wholesaler of grocery products, had no network of customers to which it might have sold the product. Therefore, as a practical matter, CSI could not sell to third parties. Petitioner argues that these contractual terms evidence that the inventory was intended by the parties to be collateral for loans.

(c) CSI did not acquire an opportunity to profit on the sale of the property or a risk of losing money because of a change in the market value of the inventory. Company A was obligated to purchase the inventory at the cost at which it sold it to CSI, even if it could buy it cheaper elsewhere. Moreover, at the termination of the agreement, Company A was obligated to pay CSI an amount equal to the consideration previously paid by CSI to Company A with respect to any remaining inventory. The carrying charge paid by Company A to CSI did not relate to the market value of the inventory. It was a charge determined by applying an interest rate to the cost of inventory in the hands of CSI. According to petitioner, this is consistent with the ownership of debt by CSI and inconsistent with true ownership of the inventory by CSI.

26. If it is determined that CSI was the owner of the food products inventory, then, petitioner argues, the receipts from the sale of the inventory are not properly included in calculation of the receipts factor because such receipts were not derived in the regular course of business within the meaning of section 4-4.1(a) of the Division's regulations. The receipts factor consists of the amount of a taxpayer's business receipts earned in New York divided by the total

amount of business receipts earned everywhere. The Division's regulations define "business receipts" as "gross income received in the regular course of business" (20 NYCRR 4-4.1[a]). Petitioner argues that the term "gross income" as used in the regulation should have the same meaning as it has for Federal income tax purposes. In section 61 of the Internal Revenue Code "gross income" is defined to include "gross income derived from business." "Gross income derived from business" is defined in Treasury Regulation 1.61-3(a) as "total sales less the cost of goods sold." Since CSI purchased inventory from Company A at cost and sold it back to Company A at cost, petitioner argues that CSI had no gross profits and thus no business receipts. Therefore, it was not required to include the amounts relating to inventory sales in its receipts factor. In fact, CSI included the carrying charges in its receipts factor for the tax years 1993 through 1997. Thus, if petitioner is correct that "business receipts" means sales less the cost of goods sold, business receipts were properly reported by CSI even if the carrying charge is viewed as profit on the sales of inventory.

Finally, petitioner argues that the imposition of a substantial understatement of tax penalty is improper. Alternatively, petitioner argues that the penalty should be abated for reasonable cause.

27. The Division argues that it properly included the Company A inventory in CSI's receipts and property factors and that the record does not support petitioner's contention that CSI was not the owner of that inventory.

(a) Initially, the Division contends that petitioner itself categorized its receipts arising from the supplemental agreement with Company A as business receipts. The Division notes that petitioner included the value of the inventory in its calculations of its New York business capital base when filing its franchise tax reports for the subject periods. The Division also notes that

petitioner included receipts from the sale of inventory to Company A in its Federal corporation income tax returns. In fact, the auditors adjusted petitioner's receipts factor, in part, because of the discrepancy between petitioner's calculation of its receipts factor and the amount of sales reported on its Federal income tax return. Thus, the Division argues, petitioner determined that it was the owner of the inventory for franchise tax purposes, for Federal income tax reporting and for its own internal accounting purposes.

(b) The Division alleges that petitioner has not carried its burden of proof to show that it was not the owner of the inventory. The Division disputes petitioner's contention that CSI had no control over the purchase of the inventory stating "the petitioner had a say in, and exercised control over, the products purchased since it made the conscious determination to rely on Company A's purchasing decisions when it insisted on buying the subject inventory as protection for its investment" (Division's brief, p. 22). The Division also notes that CSI did not purchase Company A brand products.

The Division contends that petitioner retained the right to sell inventory in its warehouse to third parties. It argues that Company A's priority claim amounted to a right of first refusal and put Company A on notice that it would be forced to purchase more inventory if it exercised that right of refusal. The Division rejects petitioner's contention that as a practical matter it had no customers to sell to, noting that CSI performed warehousing services for other retail groceries and might have been able to sell product to those customers if it wished. The Division also points out that petitioner was able to sell the inventory to mitigate damages after Company A's bankruptcy.

The Division rejects petitioner's contention that CSI did not acquire an opportunity to profit on the sale of the property because of a change in the market value of the property. The

Division emphasizes that the transactions between Company A and CSI resulted in a profit to CSI. It also notes that CSI did not acquire substantial additional costs as a result of its arrangement with Company A.

(c) The Division disputes petitioner's characterization of CSI as a bailee paid to warehouse the inventory and to finance the purchase of the inventory. It states that since petitioner had legal title to the inventory and included the value of the inventory on its balance sheets, as required by accepted rules of accounting, it must be deemed to be the owner of the property for franchise tax purposes and not a bailee.

The Division rejects petitioner's contention that "business receipts" should be interpreted to mean "gross income" as that term is defined in the Treasury Regulation. It contends that the term "business receipts" is properly defined to include receipts from the sale of tangible personal property without reduction for the cost of goods sold. The Division deems it inappropriate to resort to Federal law to define the term "business receipts" as used in article 9-A of the Tax Law. Furthermore, it argues that various sub-sections of section 4-4 of the Division's regulations support its reading of the statute.

The Division argues that the substantial underpayment penalties are warranted because petitioner did not meet its burden of proving that it had substantial authority for its argument that it was not the owner of the inventory. The Division also contends that petitioner did not adequately disclose its position at the time of the filing of the corporation franchise tax returns.

28. Petitioner takes issue with six statements of fact in the Division's brief. It labels five of these "misleading" or "incorrect" and finds the sixth statement to be an ultimate conclusion of law and fact.

29. In ***Matter of Christian Salvesen*** (Tax Appeals Tribunal, April 2, 1998), the Tax Appeals Tribunal rejected petitioner's contention that including receipts and property values relating to CSI's contract with Company A in the computation of CSI's business allocation percentage resulted in the taxation of extraterritorial values so that the Division's refusal to adjust the allocation percentage was an abuse of its discretionary authority. The parties agree that the supplemental agreement and the transactions flowing from that agreement are at the heart of the dispute in both proceedings. However, they disagree as to the effect of the prior proceeding on the instant matter. Petitioner argues that the prior proceeding has no effect since different tax years are involved and petitioner is not relying on the same arguments made in the prior proceeding. The Division argues that the Tribunal's decision in the prior proceeding should be accepted as "authoritative," apparently meaning that CSI's business receipts should be consistently calculated in the same manner for both audit periods.

CONCLUSIONS OF LAW

A. Petitioner, a foreign corporation doing business in New York, was subject to New York's corporation franchise tax during the years in issue computed upon its entire net income base. Petitioner's entire net income base means the portion of its entire net income allocable to New York. The amount of petitioner's entire net income allocable to New York is determined by multiplying petitioner's business income by its business allocation percentage ("BAP"). The BAP is determined based on three factors: property, receipts, and payroll. In arriving at an arithmetic average, the receipts ratio is counted twice. Tax Law § 210(3)(a) provides for calculating the property and receipts factors (those in issue here) as follows:

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

> (2) ascertaining the percentage which the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its entire net income, arising during such period from
>
> (A) sales of its tangible personal property where shipments are made to points within this state,
> (B) services performed within the state . . . ,
> (C) rentals from property situated, and royalties from the use of patents or copyrights, within the state, . . . and
> (D) all other business receipts earned within the state . . .
>
> bears to the taxpayer's receipts, similarly computed, arising during such period from all sales of tangible personal property, services, rentals, royalties, . . . whether within or without the state . . . .

B. It is petitioner's position that the inventory purchased and sold pursuant to the supplemental agreement should not be included in either the property or receipts factors because that inventory was owned and controlled by Company A and that the supplemental agreement, although couched in terms of a purchase and sales arrangement, was actually a financing agreement. The Division takes the position that the supplemental agreement created a contract for the purchase and sale of goods by which petitioner became the actual owner of the inventory.

The supplemental agreement contains provisions consistent with a purchase and sale agreement; however, the overall terms of the supplemental agreement, the circumstances of the arrangement and the conduct of the parties establish that the supplemental agreement was intended by the parties to be an inventory financing arrangement. The Division's arguments to the contrary are not supported by the record.

The Division refers to the carrying charge as a markup over purchase price, as the following excerpts from its brief demonstrate.

(1) "[A]t which point the petitioner would resell the products back to Company A at a mark-up over its original cost." (Division's brief, p. 2.)

(2) "[A]greement provides for petitioner to charge Company A for the products resold to Company A, at cost plus a set mark-up which is identified as a 'carrying charge' in the agreement." (Division's brief, p.6.)

Petitioner argues that these statements are misleading, and I agree. That the carrying charge was in fact a financing charge is shown by the manner in which the charge was calculated. The original carrying charge of 12 cents per case was determined by reference to the prime rate, "the average inventory balance of products purchased by CSI" and the annual average volume of cases shipped (supplemental agreement, ¶ 5; see also, footnote 1 for a description of the manner in which the original carrying charge of 12 cents per case was calculated). The carrying charge was not related to the nature or the market value of the product.

The nature of the arrangement shows that both parties understood the carrying charge to be a finance charge and not a markup on purchases. CSI was obligated to purchase inventory selected by Company A at Company A's original cost. Company A was then obligated to purchase the inventory from CSI at its original cost plus a carrying charge. There is no conceivable motive which would explain Company A's willingness to purchase products from CSI at a price higher than it originally paid for those products unless the differential was intended as a finance charge. Clearly, both parties viewed the carrying charge as a fee for the use of CSI's money.

(3) "[P]etitioner retained the right to sell the inventory to other parties." (Division's brief, p.6.)

This statement is in conflict with the evidence. Under the supplemental agreement, CSI was able to sell any of the inventory purchased from Company A to third parties, but Company

A had "priority as to availability of the Distribution Inventory" (supplemental agreement, ¶ 8[A]). Sales of product to third parties would breach the priority language of the agreement and the relationship between the parties. Moreover, Company A was obligated to purchase the inventory at CSI's cost, protecting CSI from the risk of loss stemming from changes in the market value of the inventory. Sales to third parties did not occur until Company A's bankruptcy and those sales were made at a discount to mitigate Company A's damages.

(4) "At times, Company A's purchases reached the level of the $4.5 million dollar cap. . . . When this happened, the petitioner continued to purchase products from Company A." (Division's brief, p. 8.)

This statement is in conflict with testimony in the record. Stephen Hauser, the Chief Financial Officer of Company A, testified that "if we hit that 4.5 million dollars for inventory, we stopped giving money to Company A, no funds would be transferred" (hearing transcript, p. 116). The Division has not pointed to any evidence in the record that contradicts this testimony.

(5) "[P]etitioner decided to sell all of the products it bought from Company A back to Company A under the terms of the February 1991 agreement" (Division's brief, p. 8.)

This statement is misleading. Contrary to the Division's argument, CSI did not retain the right to sell inventory to parties other than Company A. Paragraph 2 of the supplemental agreement obligates Company A to purchase the products initially sold by Company A to CSI even if the products were available elsewhere at a lower price. Paragraph 5 obligates CSI to sell the products to Company A at its invoice cost. Paragraph 8(a) provides that CSI is not prohibited from selling the products to a third party but that Company A would have priority as to the inventory. In sum, as long as Company A continued to purchase inventory CSI would

not be able to sell to others. Moreover, the Division presented no evidence that contradicted petitioner's claim that it had no retail customer base and, as a practical matter, lacked the means to sell to third parties. When CSI was forced to sell the inventory to others to mitigate Company A's damages, it sold at a loss to odd-lot buyers and not to retail grocers like Company A.

C. Other factual assertions made in the Division's brief are also incorrect. The Division asserts that CSI made a conscious decision to rely on Company A's purchasing decisions and, in this way, exercised control over the products it purchased. CSI did not exercise control over purchasing. Company A purchased the inventory it wanted from third parties, and then sold the inventory to CSI at cost. CSI was obligated under the agreement to purchase the inventory selected by Company A. The fact that Company A made all purchasing decisions demonstrates that the parties understood that the inventory was, in fact, Company A's inventory. If CSI intended to be the true owner of the inventory, it would have been expected to exercise some control over purchasing. In addition, Company A agreed to provide inventory control for no charge, a further indication that the parties viewed the inventory as belonging to Company A.

It is true, as the Division claims, that CSI profited from the arrangement with Company A. By contracting to purchase the inventory from CSI at cost, Company A guaranteed that CSI would not experience losses from its purchases. At the same time, Company A was indebted to CSI for the carrying charges of, initially, 12 cents per case which was tied to the prime interest rate. It was a fee paid by Company A to CSI for the use of CSI's money to purchase the inventory. The warehousing fees compensated CSI for the performance of warehousing services. The carrying charges compensated CSI for providing financing. The profitability of these arrangements is not in issue. What is in issue is whether CSI had an opportunity to profit

from a rise in the market value of the inventory while the inventory was in its possession. Clearly it did not. Likewise, it had no risk of loss from a decrease in the value of the inventory. Those risks were borne by Company A, indicating that Company A was the true owner of the inventory.

The Division claims that CSI was indemnified only for reimbursement of its litigation costs in case of a lawsuit. This is not the case. Company A indemnified CSI "for any liability (other than liability arising as a direct result of the negligence or willful misconduct of CSI) and for any and all liability or expenses, including . . . expenses incurred in defending actual or threatened claims and litigation" (supplemental agreement, ¶ 8[c]). Inasmuch as the expenses and liabilities arising from ownership of the property were retained by Company A, it can be concluded that actual ownership of the inventory remained with Company A.

In sum, the terms and conditions of the supplemental agreement are indicative of a financing agreement rather than a purchase and sale agreement that would have transferred true ownership of the inventory to CSI.

D. The Division contends that the Tribunal's decision in the prior proceeding (***Matter of Christian Salvesen***, ***supra***) should be accepted as "authoritative." It argues that the results in this proceeding are dictated by the Tribunal's conclusion that CSI understated its receipts and property factor for the prior audit period.[2] I disagree.

Although the facts of the two proceedings are almost identical, the issues raised are not. In the prior proceeding, the petitioner unsuccessfully argued that by including the receipts and

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[2] As support for this proposition, the Division cites to the determination of an Administrative Law Judge which states: "[since the facts] herein are strikingly similar to those found in the State Tax Commission's decision on this very issue for this same taxpayer for prior periods . . . departure from the result arrived at therein is not warranted" (Administrative Law Judge Determination, September 24, 1997). The Tribunal found that departure from the prior result was warranted and reversed the determination of the Administrative Law Judge (***Matter of Tradearbed***, Tax Appeals Tribunal, January 12, 1989).

property associated with the supplemental agreement in CSI's business receipts and property factor the Division had taxed extraterritorial values. The Tribunal held that CSI was operating a unitary business that included the financing scheme with Company A; that because the financing scheme was part of CSI's unitary business, there was no taxation of extraterritorial values; that the statutory apportionment formula did not attribute income to New York that was out of all proportion to the business transacted in New York; and that the Commissioner did not abuse his authority by refusing to make a discretionary adjustment to the statutory formula. Thus, the prior Tribunal decision did not address the issue raised here: whether CSI was the owner of the food inventory for franchise tax purposes, such that its receipts from the sale of inventory to Company A should be included in CSI's business receipts and whether the value of the food product inventory should be included in the property factor. Thus, the prior opinion of the Tribunal cannot be determinative of the issues raised here.

While the opinion of the Tax Appeals Tribunal in ***Christian Salvesen*** (***supra***) is not determinative of the outcome of this proceeding, I agree with the Division that some of the conclusions of the Tribunal in that proceeding are relevant here because the facts adduced in both proceedings are almost identical. In the proceeding before the Administrative Law Judge, the Division argued that the record did not support CSI's contention that the supplemental agreement between it and Company A was a financing arrangement. The Administrative Law Judge rejected the Division's arguments. In its decision, the Tribunal affirmed the Administrative Law Judge's determination "in its entirety based upon the reasoning and conclusions set forth therein." Thus, it adopted the Administrative Law Judge's conclusions regarding the nature of the arrangement between CSI and Company A. He found as follows:

> Moreover, the terms of the contract strongly support the inference that the contract, while structured as a sales contract, was intended to be a financing

> mechanism. First, the contract allowed Company A to purchase products at the request of CSI. The agreement contemplated CSI reselling the inventory back to Company A at the cost of the inventory plus an amount equal to the prime rate plus 2.5 percent. As noted by petitioner, tying the price into the prime rate is indicative of a financing contract. Second, under the contract, Company A agreed to provide "without any additional charge" inventory control of the items in storage ([supplemental agreement], ¶ 3.) As noted by petitioners, it is unlikely that Company A would examine the inventory without an additional charge unless Company A viewed the inventory as its own. Third, there was an agreed-upon limit to the amount of inventory that CSI would purchase. This provision would make little sense unless it was understood that the inventory was being purchased in order to be resold to Company A. Lastly, the contract provided that Company A "agrees to indemnify CSI for . . . any and all . . . expenses, including without limitation expense incurred in defending actual or threatened claims and litigation, in connection with the sale of defective or allegedly defective products." (supplemental agreement, ¶ 8[c].) Company A's willingness to indemnify CSI for all liabilities in relation to the product supports the inference that Company A considered the product to be its own. (Administrative Law Judge Determination, Division of Tax Appeals, October 31, 1996.)

I also find that the supplemental agreement between CSI and Company A created a financing arrangement with the inventory serving as collateral for CSI's loans to Company A.

E. There are two Tax Appeals Tribunal decisions cited by petitioner which lend support to this conclusion: ***Matter of Tradearbed*** (Tax Appeals Tribunal, ***supra***) and ***Matter of Emmerich Gallery*** (Tax Appeals Tribunal, March 30, 1995). The issue in both decisions is whether, pursuant to Tax Law § 210(3), the petitioner's receipts were from the sale of tangible personal property or were commissions based on services performed for another. While the CSI arrangement has nothing to do with commissions, I disagree with the Division's contention that those cases are irrelevant. In ***Emmerich***, the Tribunal stated: "The crux of the matter is that Tax Law § 210(3)(a)(2)(A) requires that the sale by the taxpayer be of '*its* tangible personal property' in order for the receipts to be treated as receipts from the sale of tangible personal property (emphasis added)." Likewise here, the heart of the matter is whether CSI actually owned the tangible personal property. Accordingly, I find the analyses of ***Tradearbed*** and

Emmerich to be instructive. In ***Tradearbed***, the Tribunal held that satisfaction of the following factors is indicative of a true agreement for sale of tangible personal property.

> 1. That the consignee receives legal title and possession of the goods.
>
> 2. That the consignee becomes responsible for an agreed price and possession of the goods.
>
> 3. That the consignee can fix the price at which he sells without accounting to the transferor for the difference between what he obtains and the price he pays.
>
> 4. That the goods are incomplete or unfinished and it is understood that the transferee is to make additions to them or complete the process of manufacture.
>
> 5. That the risk of loss by accident is upon the transferee.
>
> 6. That the transferee deals, or has the right to deal, with the goods of persons other than the transferor.
>
> 7. That the transferee deals in his own name and does not disclose that the goods are those of another.

The Tribunal found that the petitioner in ***Tradearbed*** was the purchaser and owner of goods which it resold based on its findings that the petitioner: (1) held legal title to all goods purchased; (2) fixed the prices at which it sold to its customers; (3) bore the risk of loss; (4) dealt with the goods of several mills in addition to a related mill (the Division had claimed that the petitioner was acting merely as an agent of a related mill); and (5) dealt in its own name with its customers. The petitioner's contracts of sale to its own customers indicated that sales were subject to the approval of its mills. The Tribunal found this provision incidental to the petitioner's business and not an indication of an agency relationship with the petitioner's related mills. Only factor four was inconclusive in making a determination since the record did not disclose whether the petitioner had any role in completing or altering the manufactured goods. The opposite result was reached in ***Emmerich*** by application of the same factors. Significantly, although the petitioner in ***Emmerich*** acquired legal title to the goods in its possession, the

Tribunal found this factor not conclusive when other facts indicate that a seller is acting as an agent for another person.

The seven factors discussed in ***Tradearbed*** and ***Emmerich*** are not directly relevant here, but a few pertinent principles can be gleaned from those cases. First, a taxpayer has receipts for purposes of Tax Law § 210(3)(a)(2)(A) only if it has receipts from the sale of its own tangible personal property. Second, to determine whether a taxpayer is the actual owner of tangible personal property, it is necessary to look at all of the facts and circumstances that indicate true ownership or lack of it. Third, the holding of legal title to the goods in its possession is not conclusive when the facts indicate that the taxpayer lacks other important indicia of true ownership. The supplemental agreement between CSI and Company A and the facts and circumstances of their relationship and business arrangements establish that CSI was not the true owner of the inventory.

A Federal Tax Court case cited by petitioner (***Peccar, Inc. v. Commr.***, 85 TC 754) also supports its claim. There, the issue was whether a taxpayer's transfer of obsolete inventory to an unrelated warehouse facility ("SAJAC") constituted a sale. The IRS argued that the taxpayer retained such a high degree of control over the inventory that the purported sales could not be classified as completed sales transactions. Although the contract between the taxpayer and SAJAC used the words "sell," "repurchase," and "selling price" and purported to transfer title to and ownership of the property to SAJAC, the court concluded that SAJAC merely warehoused the inventory for the taxpayer and was not the true owner. Its decision was based on its findings that (1) SAJAC exercised no discretion over what it accepted into inventory; (2) the taxpayer was the one who decided when to scrap the inventory; (3) SAJAC was denied the right to sell the inventory to anyone other than the taxpayer for a period of four years; and (4)

when requested, SAJAC was denied the right to alter the inventory. The same analysis demonstrates that CSI was not the true owner of the inventory. CSI exercised no control over what it accepted into inventory, despite the fact that it was ostensibly purchasing the products that it accepted. Company A decided what inventory to purchase from third parties and when it wanted CSI to distribute that inventory to it. In light of Company A's priority claim over the inventory, CSI could not sell the inventory to others. At the termination of the agreement, Company A was required to purchase back all product remaining in inventory. Under these circumstances, the transactions between CSI and Company A were not true sales.

F. The Division's arguments for viewing CSI as the true owner of the inventory are not persuasive. It notes that CSI included the value of the inventory in the calculation of its assets for several purposes. It included the value of the inventory in its calculation of its capital base on its New York franchise tax return; it included the same amounts as inventory on its Federal income tax returns and in its own financial statements; CSI included its sales to Company A in its calculation of gross receipts on its Federal income tax returns and in its own audited financial statements. Thus, the Division argues, CSI has determined for itself that it was the owner of the inventory for New York franchise tax purposes.

I agree with petitioner that CSI's treatment of the inventory for Federal income tax and financial accounting purposes does not contradict the position taken in this proceeding: that the inventory served as collateral for its loan to Company A providing CSI with nominal ownership of the inventory. Since CSI bought and sold the inventory at cost, reporting these receipts as sales had no effect on its Federal income tax liability or on its calculation of profits. Moreover, petitioner reported the carrying charges as New York receipts on its franchise tax returns. Thus, the profits earned by CSI on the financing arrangement were reported and taxed by New

York. The only question is whether the at-cost sales to Company A should be treated as receipts from the sale of CSI's tangible personal property and whether the value of the inventory should be included in the property factor. Since it has been concluded that CSI was never the true owner of the inventory, there is no basis for treating receipts from those sales as CSI's business receipts. Likewise, there is no statutory basis for including the value of the inventory in the calculation of petitioner's BAP.

Since the supplemental agreement between CSI and Company A was, in fact, an inventory financing arrangement, CSI's corporation franchise tax returns are correct, and the Notice of Deficiency must be canceled.

G. Inasmuch as the first issue has been decided in petitioner's favor resulting in cancellation of the Notice of Deficiency, there is no reason to address other issues raised by petitioner.

H. The petition of CS Integrated, LLC is granted, and the Notice of Deficiency, dated November 12, 1999, is canceled.

DATED: Troy, New York
May 9, 2002

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE