STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **NEW YORK FUNERAL CHAPELS, INC.** **F/K/A WALTER B. COOKE, INC.** for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1993, 1994 and 1995.	: : : : : :	DETERMINATION DTA NO. 818854

Petitioner, New York Funeral Chapels, Inc., f/k/a Walter B. Cooke, Inc.,[1] 1929 Allen Parkway, Houston, Texas 77019, 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, 1994 and 1995.

On August 26, 2002, petitioner by its representative, Gregory L. Bonyne, Esq., and on September 5, 2002, the Division of Taxation by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel) waived a hearing and agreed to submit this case for determination, with all documents and briefs to be submitted by the parties by February 14, 2003, which date began the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Frank W. Barrie, Administrative Law Judge, renders the following determination.

ISSUE

Whether the Division of Taxation properly limited petitioner's net operating loss deductions for the years 1993 through 1995 based upon a prior audit of the earlier years of 1991

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[1] Walter B. Cooke, Inc., a New York corporation, changed its name to New York Funeral Chapels, Inc. in 1996.

and 1992, which had resulted in discretionary adjustments to petitioner's entire net income in order to properly reflect petitioner's New York income for such earlier years.

FINDINGS OF FACT

1. Petitioner, which owns and operates funeral homes solely within New York, is part of an international enterprise that operates under the umbrella organization known as Service Corporation International ("SCI"). SCI is the largest owner and operator of funeral homes, cemeteries and crematoria in the world: 2,631 funeral homes, 250 cemeteries and 137 crematoria in North America, France, Great Britain and Australia. During the 1990s, it performed approximately 9%, 29%, 14% and 24% of the funeral services in North America, France, Great Britain and Australia, respectively. SCI, headquartered in Houston, Texas, acts as a holding company, provider of management services, and central bank for the entire international enterprise.

2. On December 31, 1991, pursuant to a tax-free reorganization under the Internal Revenue Code ("IRC") § 368(a)(1)(A), 24 affiliated corporations were merged into petitioner in a corporate restructuring. These 24 affiliated corporations included entities that operated funeral homes in the New York City metropolitan area, such as Frank E. Campbell- The Funeral Chapel and Boulevard-Riverside Chapels, Inc., as well as some entities related to funeral services, such as Hygrade Casket Corporation and Walter B. Cooke, Livery Corporation. During the years at issue, 1993 through 1995, petitioner operated over 20 funeral homes and other related funeral services in the New York City metropolitan area.

3. Petitioner reported total tax due of $1,094,544.00 for the three years at issue on total entire net income reported for the three years of $7,419.472.00,[2] with total gross receipts for the three years of $137,757,512.00. After an audit of petitioner's returns, entailing 341.5 audit hours, the Division of Taxation ("Division") allowed a refund/credit of $67,970.00.

4. Subsequently, petitioner filed a refund claim dated October 21, 1999, by which it sought an additional tax refund in the amount of $327,773.00 consisting of the following:

Description	1993	1994	1995	Total
Article 9-A tax	$ (11,793.00)	$(192,722.00)	$(79,068.00)	$(283,583.00)
Metropolitan Commuter Transportation District surcharge	(2,564.00)	(29,122.00)	(12,504.00)	(44,190.00)
Total	$(14,357.00)	$(221,844.00)	$(91,572.00)	$(327,773.00)

According to petitioner's refund claim,[3] the additional refund was based upon the following five adjustments to its returns as originally filed:

> 1. Adjustment of [Net operating loss deduction] to reflect carryover of [Net operating loss deductions] transferred to taxpayer as a result of mergers that occurred on December 27, 1991.
>
> 2. Adjustment of charitable contribution deductions to reflect carryover of charitable contributions transferred to Taxpayer as a result of mergers that occurred on December 27, 1991.
>
> 3. Adjustment of 1993 and 1994 entire net income to remove capital losses.

[2] Petitioner reported entire net income of $4,422,746.00 for 1995, $3,771,608.00 for 1994, and a loss of $774,882.00 for 1993. It calculated tax on its net income, allocated 100% to New York, of $396,920.00 for 1995 and $299,352.00 for 1994. Since it reported a loss for 1993, petitioner calculated tax due of $107,019.00 for 1993 by the alternative computation of minimum taxable income base and tax. On its U.S. corporation income tax returns ("as if" it had filed separately), petitioner reported taxable income of $2,281,903.00, $3,035,638.00 and $4,120,052.00 for 1993, 1994 and 1995, respectively.

[3] Although the refund claim dated October 21, 1999 specified multiple adjustments, by an undated stipulation of the parties received by the Division of Tax Appeals on October 15, 2002, the parties agreed that petitioner "is entitled to the refunds claimed *in full*" if it should prevail on the "only issue in this case" which has been stated at the start of this determination [emphasis added]. There is no specific explanation in the record for this variance, but it appears that the Division of Taxation has accepted petitioner's other delineated adjustments so that if it prevails on the issue in this matter, its refund claim will be granted *in toto*.

> 4. Adjustment of 1993 entire net income to remove dividend income from subsidiary capital.
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> 5. Adjustment of 1993-1995 entire net income to reflect additional depreciation deductions resulting from Federal RAR.

In addition, petitioner's refund claim was based upon what it labeled the Division's "improper disallowance of 1993-1995 [Net operating loss deductions]." According to the claim, "[a]djustments of 1990 and 1991 [Net operating loss deductions] resulting from § 211(5) adjustments made to entire net income in 1990 and 1991 are not allowed pursuant to statute [to reduce net operating loss deductions for the years at issue]." Petitioner deducted net operating loss carry-forwards from 1991 in determining its New York corporation franchise tax liability in the following amounts: for 1993, $3,124,719.00; for 1994, $0; and for 1995, $312,474.00.

5. By a letter dated January 7, 2000, the Division denied petitioner's refund claim and provided the following explanation:

> The additional amounts being claimed for refund are largely based on the issue of the amount of the net operating loss deduction you contend to be allowable in each of the years. Most of the net operating loss deductions being claimed arose from the reported carryforward of net operating losses reported in years prior to 1993. We . . . still believe that our determination is correct and 1) that federal taxable income is the starting point in the computation of entire net income for New York, 2) that each corporation included in a federal consolidated group must compute its federal taxable income as if such corporation had computed its federal taxable income on a separate basis, 3) that a determination was made during the audit of calendar years 1990 and 1991 that management fees paid to affiliated corporations included in the federal consolidated group and deducted in the computation of federal taxable income were overstated, and 4) that these overstatements resulted in the understatement of federal taxable income on an "as if" basis and in a distortion of New York income.

The Earlier Audit of 1990 and 1991

6. For the years 1990 and 1991, Walter B. Cooke, Inc. filed a combined New York corporation franchise tax return with approximately[4] 23 sister corporations ("combined New York group") also affiliated with the parent entity, SCI, which was *not* a member of the combined New York group for state franchise tax purposes. The combined New York group filed on a consolidated basis with their parent entity, SCI, and other affiliates for *Federal* income tax purposes as the "SCI consolidated group."

7. As noted in Finding of Fact "2", it was not until the end of 1991 that all of the members of this combined New York group were merged into petitioner. In fact, SCI restructured its entire international operations at the end of 1991, and many of the 450 affiliates included in its Federal consolidated returns for 1991 were also merged into other affiliates. In 1992, after the restructuring, only 11 separate returns and no combined returns were filed in New York. The basic reason for the corporate restructuring was to group sister entities into geographic clusters, which could then be more efficiently operated.

8. The combined New York group claimed significant deductions for fees paid to SCI[5] of $7,379,479.00 for 1990 and $12,548,527.00 for 1991. These amounts represented the cost of administrative services (i.e., tax, legal, accounting, MIS, real estate, corporate development, etc.) provided by SCI to the combined New York group marked up by 25 percent. For 1990 and 1991, the combined New York group reported net operating losses of $29,335.00 and $3,171,011.00, respectively.

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[4] The audit report for these earlier years used the term "approximately," and since the tax returns for 1990 and 1991 were not included in the record, the exact number of affiliated corporations which filed together on a combined return for each of these years could not be determined.

[5] The parties stipulated that the fees were paid to "certain members of the [SCI] affiliated group."

9. After an audit, entailing 643.00 audit hours, of the New York corporation franchise tax returns of the combined New York group for these earlier years, the Division determined that SCI had allocated excessive fees based upon a 25% markup of the parent's expenses to the combined New York group. Further, interest expense was included in the parent's pool of expenses which were marked up and allocated to the combined group despite the fact that SCI separately charged the members of the combined New York group interest on loans at a market rate. The Division and petitioner reached a compromise resulting in a discretionary adjustment by the Division to the entire net income of the combined New York group for each of these earlier years. The management fees were reduced to the parent's cost plus 15% and interest was eliminated from the pool of management expenses to be allocated as fees to the members of the combined New York group. Under such compromise, the amount of fees deducted by the combined group was reduced by the following amounts: for 1990, $2,698,960.00; for 1991, $5,265,824.00.[6] Before such adjustment, the entire net income reported by the combined group for 1991 was negative $3,067,465.00. After such adjustment, the entire net income of the combined group for 1991 was a positive $2,198,359.00.

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[6] These significant reductions were calculated as follows:

	1990	1991
(1) Original management fee charged by SCI to petitioner @ cost plus 25%	$7,379,479.00	$12,548,527.00
(2) Original management fee @cost	5,903,583.00	10,038,822.00
(3) Interest income expense included in management fee duplicating interest paid on loans to SCI by petitioner	(1,833,567.00)	(3,706,036.00)
(4) Original management fee @ cost less interest income expense	4,070,016.00	6,332,786.00
(5) Original management fee @ cost less interest income expense plus 15% markup	$4,680,519.00	7,282,703.00
(6)Reduction to original management fee (add-back); Line 1 less line 5	$2,698,960.00	$5,265,824.00

10. The Division, in lieu of the adjustment detailed above, had considered requiring a combined report covering petitioner, its parent, SCI, and all of the approximately 450 affiliates on the consolidated federal return since its auditor determined that stock ownership, unitary business and distortion requirements were met each year. However, the audit report noted as follows:

> [A] combined return [covering so many entities] would be very difficult administratively. Therefore, in lieu of a combined report, a discretionary adjustment under New York Stat [sic] Tax Law section 211.5 has been made to entire net income.

11. The parties entered into a stipulation of facts and exhibits, which was received on October 15, 2002. Relevant portions have been incorporated herein.

SUMMARY OF THE PARTIES' POSITIONS

12. The Division maintains that the agreed-to discretionary adjustments for the earlier years were made to properly reflect petitioner's New York State income and resulted in profits and not losses for 1990 and 1991. Furthermore, the discretionary adjustment for 1991 fixed whether, and the extent to which, any net operating loss existed in 1991 for purposes not only of 1991 but also for purposes of computing any derivative carry-forward to the years at issue. By its discretionary adjustment, the Division argues that it allowed the portion of the management fee expenses that were ordinary and necessary pursuant to IRC § 162(a) and disallowed the rest. The Division maintains that the result would be "incongruous" to adjust a taxpayer's deductions in one year and not have those results carry through to future years (Division's brief, p. 13). According to the Division, the Commissioner's discretionary adjustment authority under Tax Law § 211(5) represents an overlay to the computation provisions of Tax Law § 208(9). Under such computation provisions, petitioner's New York net operating loss deductions are only

"presumably" the same as its federal, and in the situation at hand, the 1993-1995 federal net operating loss deductions may be adjusted on the basis of the 1990-91 audit adjustment.

13. Petitioner denies that any distortion arose from the management fees paid by the New York combined group to SCI based upon a markup of 25%, and the reduction to a 15% markup was a compromise, by which it did not concede "distortion." Petitioner contends that "There is no evidence that demonstrates that the management fee paid by Petitioner was not ordinary and necessary or that the settled amount was" (Petitioner's reply brief, p.3). Further, according to petitioner, the discretionary adjustments to petitioner's New York entire net income did not affect its *federal* taxable income and net operating losses for 1990 and 1991 since nothing in Tax Law § 211(5) gives the Division the power to change the definition of federal taxable income. Even if the parties in fact did not deal with each other at arm's length, petitioner contends only the IRS and not the Division has the "discretion [under IRC § 482] to reallocate items of income and deduction between related taxpayers" (Petitioner's reply brief, p. 4). Petitioner emphasizes that Tax Law § 208(9)(f) provides the "exclusive mechanism for determining the New York State net operating loss deduction." Adjustments made by the Division in earlier years using its discretionary authority under Tax Law § 211(5) are not referenced in § 208(9)(f) (Petitioner's brief, p. 5). Petitioner suggests that "If the Division feels that the statute reaches an inappropriate result, its proper recourse is to the Legislature" (Petitioner's brief, pp. 13-14).

CONCLUSIONS OF LAW

A. The Commissioner's discretionary authority under Tax Law § 211(5) is at the heart of this matter. This provision provides, in relevant part, as follows:

> In case it shall appear to the tax commission[7] that any . . . arrangement exists between the taxpayer and any other corporation . . . , whereby the . . . income . . . of the taxpayer within the state is . . . inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income, deductions . . . so as equitably to determine the tax.

B. Here, as noted in Finding of Fact "9", the Division of Taxation transformed petitioner's reported loss for 1991 of $3,067,465.00 into entire net income for the year of $2,198,359.00 by exercising its authority under Tax Law § 211(5). As noted in Finding of Fact "9", the Division determined during audit that petitioner's parent, SCI, had allocated excessive fees to petitioner (i) by marking up its expenses by an unreasonably high 25% and (ii) by including interest expenses in the pool of expenses it marked up since it separately charged petitioner with interest on loans at a market rate. Based upon this determination, the Division pursuant to Tax Law § 211(5) adjusted petitioner's deductions from income for 1990 and 1991 by reductions of $2,698,960.00 and $5,265,824.00, respectively, so as to more accurately reflect petitioner's income within New York.

C. Petitioner denies that any distortion arose from the fees paid by petitioner to its parent, SCI and that there is no evidence in the record that such fees were not ordinary and necessary. It contends that the adjustment under Tax Law § 211(5) was merely a compromise between the parties. This contention, in substance, is an attempt to shift the burden of proof of a critical factual matter on to the Division and is rejected (***cf.***, ***Matter of Orvis***, Tax Appeals Tribunal, January 14, 1993, ***annulled in part*** 204 AD2d 916, 612 NYS2d 503, ***modified*** 86 NY2d 165, 630 NYS2d 680, ***cert denied*** 516 US 989, 133 L Ed 2d 426 [wherein the Tribunal noted that the Division of Taxation does not have the burden of proving the propriety of its assessment, but

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[7] Effective September 1, 1987, under Tax Law § 2026, references to the State Tax Commission in the Tax Law, in all instances other than in relation to the administration of the administrative hearing process, are deemed to refer to the Division of Taxation or Commissioner of Taxation and Finance.

rather the failure of the petitioner in Orvis to "establish the specific facts" required the Tribunal to "conclude that petitioner has not sustained its burden"]). The fees at issue were reduced by approximately $8,000,000.00 for a two-year period after the auditor considered but then rejected, due to the administrative difficulties, requiring a combined report of approximately 450 entities, as noted in Finding of Fact "10". The significant $8,000,000.00 reduction, in lieu of a combined report, agreed to by petitioner or not, provides a reasonable basis to conclude that petitioner's income within New York as reported was not accurately reflected. Consequently, it may be concluded that the portion of the fees disallowed by the Division's adjustment were not ordinary and necessary business expenses and distorted petitioner's income to New York in 1990 and 1991.

D. Tax Law § 210(1) provides that the corporation franchise tax is to be computed by whichever of four alternative methods results in the greatest tax. The method at issue here consists of a tax of 9% on petitioner's entire net income base. Tax Law § 210(1)(a) provides that "entire net income base" means "the portion of the taxpayer's entire net income allocated within the state." Since petitioner allocates 100% of its income to New York, the focus is upon what constitutes petitioner's "entire net income" for the three years at issue.

E. Pursuant to Tax Law § 208(9), "entire net income" for New York corporation franchise tax purposes "means total net income from all sources, which shall be presumably the same as the entire taxable income . . ., (i) which the taxpayer is required to report to the United States treasury department . . . ." In turn, at Tax Law § 208(9)(f), "a net operating loss deduction" for New York corporation franchise tax purposes "shall be presumably the same as the net operating loss deduction allowed under [IRC §172] . . . ." Petitioner proposes an interpretation of this provision which would ignore the adjustment detailed in Conclusion of Law "C" since petitioner's Federal ("as if" filed separately[8]) returns for the years at issue did not reflect the Division's reduction of the approximately $8,000,000.00 in petitioner's business expenses for the two earlier years of 1990 and 1991. Petitioner's proposition, which is based upon the carrying forward of operating losses for 1990 and 1991 that have been, in fact, transformed into operating income by the Division's earlier audit, would undermine the purpose of Tax Law § 211(5) to defeat tax avoidance by shifting income out of New York by exaggerating expenses paid to a non-New York taxpayer. Nonetheless, petitioner contends that since Tax Law § 208(9)(f) fails to specifically reference adjustments made under Tax Law § 211(5), there is no statutory authority to support the Division's position, and the Division's "proper recourse is to the Legislature."

F. Petitioner's argument fails to adequately consider the purpose of the net operating loss deduction (***see***, ***American Can Company v. State Tax Commission***, 37 AD2d 649, 323 NYS2d 6, 9 [wherein the Appellate Division confirmed the former Commission's rejection of a taxpayer's argument that a literal interpretation of Tax Law § 208(9)(f) should be applied, based upon the court's concern that the statutory language to be construed "should not 'be at war with the plainest principles of reason and justice' (citation omitted)"]). In ***American Can Company***, the taxpayer sought to utilize the net operating loss from earlier years of a non-New York entity that had been merged into it. The net operating loss was the result of operations outside of New York by this non-New York enterprise although the "taxpayer," whose franchise tax liability was being determined, was subject to New York tax in the earlier period. At issue was the statutory condition that no losses may be included which were incurred in any taxable year in which the

[8] Petitioner filed a consolidated Federal return with SCI so that it was *irrelevant* for Federal purposes whether petitioner's income was distorted by the payment of excessive fees to the parent corporation.

"taxpayer" was not subject to the franchise tax. It was deemed unreasonable to take into consideration such loss for purposes of calculating the New York corporation franchise tax liability of the taxpayer, despite the use of the term "taxpayer"(which meant the successor entity, i.e., American Can Company) in section 208(9)(f). The court confirmed the Commission's refusal to interpret this term in an unyielding, literal fashion. Otherwise, the taxpayer in ***American Can Company*** would be claiming a net operating loss in New York which it did not actually incur. Here, similarly, the Division is correct that it would be "incongruous," or in the court's words "at war with the plainest principles of reason and justice," to adjust a taxpayer's deductions in one year resulting in the transformation of a net operating loss into income and not have those results carry through to future years. Otherwise, petitioner which did *not* have a net operating loss in New York for the earlier period (like the taxpayer in ***American Can Company***) would be able to claim a net operating loss in New York it too did not actually incur. Consequently, the Division's interpretation of section 208(9)(f) which places emphasis on the term "presumably," and gives effect to (and does not ignore) the adjustment made under section 211(5) for earlier years is a reasonable interpretation of the statutory provision governing the computation of net operating loss deduction for New York corporation franchise tax purposes and should be upheld (***see***, ***Custom Shop Fifth Avenue v. Tax Appeals Tribunal***, 195 AD2d 702, 600 NYS2d 295). In this way, these two sections of the Tax Law may be harmonized with each other.

G. Further, the decision of the Tax Appeals Tribunal in ***Matter of Bausch & Lomb Inc.*** (July 19, 1990), as well as two decisions of the Court of Appeals from 1919 and 1923 in ***People ex. rel. Barcalo Mfg. Co. v. Knapp*** (227 NY 64) and ***People ex rel Standard Oil Co. v. Law***, (237 NY 142), respectively, all cited by petitioner, do not dictate a different result. These decisions did not address the overlapping effect of Tax Law § 211(5), the statutory provision at the heart of this matter, on Tax Law § 208(9)(f). In addition, other Appellate Division decisions cited by petitioner are not as close on the facts to the matter at hand as ***American Can Company*** discussed above.

H. In conclusion, petitioner has not met its burden to show not only that its interpretation of the law is plausible, but also that its interpretation is the only reasonable construction available (***see***, ***Mobil Intl. Fin. Corp. v. State Tax Commn.***, 117 AD2d 103, 501 NYS2d 947, 949).

I. The petition of New York Funeral Chapels, Inc. f/k/a Walter B. Cooke, Inc. is denied, and the Division's disallowance of its refund claim dated January 7, 2000 is sustained except to the extent the Division has agreed to such refund claim as noted in Footnote "3".

DATED: Troy, New York
July 3, 2003

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE