STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **THE H. W. WILSON COMPANY, INC.** for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended March 31, 1996, March 31, 1997 and March 31, 1998.	DETERMINATION DTA NO. 819039

Petitioner, The H. W. Wilson Company, Inc., 950 University Avenue, Bronx, New York 10452, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended March 31, 1996, March 31, 1997 and March 31, 1998.

A small claims hearing was held before James Hoefer, Presiding Officer, at the offices of the Division of Tax Appeals, 1740 Broadway, New York, New York on January 21, 2004 at 1:15 P.M. Petitioner appeared by Cohen & Schaeffer, P.C. (Steven Schaeffer, CPA). The Division of Taxation appeared by Mark F. Volk, Esq. (Craig Wolf and Dinesh Khanna).

Since neither party herein elected to reserve time to file a post-hearing brief, the three-month period for the issuance of this determination began as of the date the hearing was held.

ISSUE

Whether the Division of Taxation properly determined that petitioner, The H. W. Wilson Company, Inc., and its subsidiary, The H. W. Wilson Company, Inc., FSC, were required to file combined franchise tax returns for the fiscal years ended March 31, 1996, March 31, 1997 and March 31, 1998.

FINDINGS OF FACT

1. Petitioner herein, The H. W. Wilson Company, Inc., was incorporated in New York on December 26, 1913. Petitioner's main business activity is the printing and publishing of books, periodicals and reference indices which are sold primarily to schools, universities and libraries. There are approximately 200 people employed at petitioner's principal office and plant facilities located in the Bronx, New York.

2. On June 12, 1995, petitioner created the subsidiary The H. W. Wilson Company, Inc., FSC ("Wilson FSC"), a foreign sales corporation ("FSC") incorporated in the United States Virgin Islands. Petitioner owns 100% of the stock of Wilson FSC and it is the only subsidiary in the parent-subsidiary controlled group.

3. Petitioner filed timely general business corporation franchise tax returns and MTA surcharge returns with the Division of Taxation ("Division") for the fiscal years ended March 31, 1996, March 31, 1997 and March 31, 1998. For the three years at issue petitioner did not file combined returns with Wilson FSC.

4. Based on the results of a field audit, the Division proposed certain adjustments[1] to the returns as filed by petitioner. The only adjustment at issue in this proceeding is the Division's use of its discretionary authority to require petitioner to file combined returns with Wilson FSC. On audit, the Division determined that petitioner owned all of the stock of Wilson FSC, that petitioner and Wilson FSC conducted a unitary business, and that there were substantial intercorporate transactions between petitioner and Wilson FSC. Apparently relying on Tax Law former § 211(4) and (5) and regulations 20 NYCRR 6-2.2(a), (b); 6-2.3 and 6-2.5, the Division

[1] The Division did not introduce into the record its field audit report and related workpapers or the statement of proposed audit changes. Accordingly, other than the combined filing issue, the record does not reflect what other adjustments were made as the result of the field audit.

determined that, since petitioner had substantial intercorporate transactions with Wilson FSC, combined returns were required to properly reflect petitioner's corporate franchise tax liability for the three fiscal years under review.

5. On April 16, 2001, the Division issued a Notice of Deficiency to petitioner asserting that for the three years in dispute the following amounts of corporate franchise tax and MTA surcharge were due, together with interest:

ITEM	**FYE 3-31-96**	**FYE 3-31-97**	**FYE 3-31-98**
Franchise tax due	$581.00	$377.00	$181.00
MTA surcharge due	79.00	54.00	27.00
Total tax due	$660.00	$431.00	$208.00

6. FSC's were established by the Tax Reform Act of 1984 and were designed to be the primary vehicle to promote exports. Generally, if a FSC maintains a presence outside the United States, is managed outside the United States, performs certain sales and economic process activities outside the United States and deals with its related suppliers[2] at arm's length, then a portion of its income will be exempt from Federal tax. A FSC generally acts as either a principal (a/k/a buy-sell FSC) or a commission agent (a/k/a commission FSC) for export transactions. Wilson FSC was a commission FSC for the period in dispute. Gross receipts of a FSC and related suppliers include all receipts that a FSC and related suppliers earn from export transactions. A FSC's foreign trade gross receipts and foreign trade income are computed by applying certain pricing rules to the gross receipts or net income of the FSC and related suppliers.

[2] In this matter Wilson FSC had only one related supplier, to wit, its parent (the petitioner herein) The H. W. Wilson Company, Inc.

7. There is no dispute that Wilson FSC properly elected and met the conditions necessary to be considered and taxed as a FSC pursuant to the relevant provisions of the Internal Revenue Code (IRC) (***see,*** IRC §§ 921-927). There is likewise no dispute that petitioner's U.S. corporation income tax returns (forms 1120) and Wilson FSC's U.S. income tax returns of a foreign sales corporation (forms 1120-FSC) properly met and applied all relevant provisions of the IRC.

8. For all three years at issue, Wilson FSC elected to be treated as a small FSC in accordance with IRC § 922(b). A small FSC is designed to be used primarily by small exporters who find that it is not economically feasible to support the costs associated with a foreign office or foreign economic activities. While a FSC that does not elect to be treated as a small FSC is required to meet the foreign management and foreign economic process requirements of IRC § 924(c) and (d) in determining its foreign trading gross receipts, a small FSC is exempt, pursuant to IRC § 924(b)(2)(A), from satisfying these requirements. Thus, a small FSC's activities are minimal since it is not required to maintain a bank account or office outside the United States and it is not required to participate in the solicitation, negotiation or making of the contract for the export sale.

9. The exempt foreign trade income of both a FSC and a small FSC is treated as foreign source income not effectively connected with the conduct of a trade or business within the United States and, as such, is not subject to Federal income tax. The foreign trade gross receipts of Wilson FSC, a commission FSC, is the same figure as petitioner's foreign gross receipts. Wilson FSC chose to use the administrative pricing rules of IRC § 925(a)(2), specifically the 23% of combined taxable income method, to allocate the foreign trade taxable income between it

and petitioner and to compute its taxable and exempt foreign trade income. The following table reflects how Wilson FSC computed these amounts on forms 1120-FSC:

ITEM	**FYE 3-31-96**	**FYE 3-31-97**	**FYE 3-31-98**
Foreign trade gross receipts	3,474,854.00	1,847,524.00	2,689,848.00
Less: allocable cost of goods sold	(2,043,376.00)	(1,105,592.00)	(1,687,679.00)
petitioner's allocable expenses	(756,352.00)	(332,610.00)	(674,905.00)
FSC's direct expenses	(3,650.00)	(3,050.00)	(3,050.00)
Combined foreign taxable income	671,476.00	406,272.00	324,214.00
Allocation percentage	x 23%	x 23%	x 23%
Wilson FSC profit	154,439.00	93,443.00	74,569.00
Add: FSC's direct expenses	3,650.00	3,050.00	3,050.00
Wilson FSC foreign trade income	158,089.00	96,493.00	77,619.00
Exemption percentage	x 65.217%	x 65.217%	x 65.217%
Exempt foreign trade income	103,101.00	62,930.00	50,621.00
Nonexempt foreign trade income	54,988.00	33,502.00	26,998.00

10. The foreign trade gross receipt amounts shown in the above table represent sales made by petitioner to unrelated third-party foreign customers. To determine combined taxable income from foreign sales, Wilson FSC deducted, from foreign trade gross receipts, petitioner's cost of goods sold attributable to export goods, petitioner's other expenses allocable to export goods, and direct expenses incurred by it. The Division does not dispute that the above table accurately reflects the combined taxable income of petitioner and Wilson FSC, or that the administrative pricing rules of IRC § 925(a)(2), that is the 23% of combined taxable income method, were properly applied by petitioner and its subsidiary.

SUMMARY OF THE PARTIES' POSITIONS

11. Petitioner argues that the Division cannot rely on the presumption of distortion to require combined returns since there were no substantial intercorporate transactions between itself and Wilson FSC. Petitioner asserts that because Wilson FSC chose to be treated as a small FSC, it in essence conducted minimal or no business activities, and thus it could not have had any intercorporate transactions, mush less any substantial ones. Petitioner maintains that since Wilson FSC is a small FSC, the only transaction that occurred, if it can be characterized as one, resulted from the accounting necessary to allocate the foreign gross income between it and the FSC.

12. Petitioner next asserts that if it is determined that substantial intercorporate transactions existed between it and Wilson FSC, thereby giving rise to the presumption of distortion, then it has established that the intercorporate transactions were conducted at arm's length. Specifically, petitioner argues that, in the instant matter, Wilson FSC's only source of income was its allocated share of net profit from foreign sales made by petitioner to unrelated third parties. Since it is undisputed that petitioner conducted business at arm's length with its unrelated third-party foreign customers, it must follow that Wilson FSC's allocated share of these foreign revenues must also be at arm's length.

13. Finally, petitioner contends that the filing of separate returns with Wilson FSC properly reflected its tax liability for the years at issue. Petitioner notes that the additional tax due asserted by the Division, on average $433.00 per year, is insignificant in relation to the tax due as reported on its returns, on average $16,033.00 per year. Petitioner maintains that the additional tax due resulting from combined returns is so small it can only be concluded that its separate returns properly reflected its tax liability for each year in question.

14. The Division argues that there were substantial intercorporate transactions between petitioner and Wilson FSC, thus creating a presumption of distortion and the necessity for combined returns. While the Division concedes that Wilson FSC's activities or transactions in relation to petitioner's are minor, viewed from the perspective of Wilson FSC most, if not all, of its transactions were conducted with petitioner.

CONCLUSIONS OF LAW

A. Tax Law former § 211(4) provided that:

> In the discretion of the commissioner, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations . . . may be required or permitted to make a report on a combined basis covering any such other corporations . . . *provided*, *further*, that no combined report covering any corporation not a taxpayer shall be required unless the commissioner deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, *in order properly to reflect the tax liability under this article* . . . (Tax Law former § 211[4]; emphasis added).

Former section 211(5) provided, in relevant part, that:

> In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is *improperly or 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 and capital, and to eliminate assets in computing any allocation percentage provided only that any income directly traceable thereto be also excluded from entire net income, *so as equitably to determine the tax* (Tax Law former § 211[5]; emphasis added).

B. The Commissioner's regulations at 20 NYCRR 6-2.5(a) state that:

> A foreign corporation will not be required to be included in a combined report unless the requirements described in section 6-2.2 of this Part have been met and the [Commissioner] determines that inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:

(1) substantial intercorporate transactions . . . .

C. Regulation 20 NYCRR 6-2.2 provides, in turn, that a combined return may be required or permitted where the capital stock and unitary business requirements are met. In the instant matter, there is no dispute that these requirements are satisfied. Regulation 20 NYCRR 6-2.3(b) goes on to provide that the Commissioner, once the capital stock and unitary business requirements have been met, may:

> permit a corporation which is not a taxpayer to be included in a combined report if reporting on a separate basis distorts the . . . income . . . of one or more taxpayers. The . . . income . . . of a taxpayer will be presumed to be distorted . . . if there are substantial intercorporate transactions among the corporations.

D. Substantial intercorporate transactions are defined in 20 NYCRR 6-2.3(c) in the following manner:

> In determining whether there are substantial intercorporate transactions, the [Commissioner] will consider transactions directly connected with the business conducted by the taxpayer, such as:
>
> (1) manufacturing or acquiring goods or property or performing services for other corporations in the group;
>
> (2) selling goods acquired from other corporations in the group;
>
> (3) financing sales of other corporations in the group; or
>
> (4) performing related customer services using common facilities and employees.

E. The first issue to address is whether petitioner had substantial intercorporate transactions with Wilson FSC, thus creating the presumption of distortion. Since Wilson FSC has elected to be treated as a small FSC, it is exempt from meeting the foreign management and foreign economic process requirements of IRC § 924(c) and (d), and thus its business activities are indeed minimal. Although Wilson FSC's activities are minimal, I agree with the Division

that there were in fact substantial intercorporate transactions during each year at issue. The table shown in Finding of Fact "9" reflects that the only costs incurred by Wilson FSC were direct costs totaling $3,650.00 for the fiscal year ended March 31, 1996, and $3,050.00 for each of the last two years under review. With the exception of these minimal direct expenses, all costs of goods, other expenses and services, including accounting and legal, were paid for or provided by petitioner to Wilson FSC. Given the fact that Wilson FSC is an electing small FSC, and, as such, essentially a paper entity, there must be by the very nature of the relationship between petitioner and Wilson FSC substantial intercorporate transactions (***see,*** 20 NYCRR 6-2.3[f] example 1).

F. In ***Matter of Silver King Broadcasting of N.J., Inc.*** (Tax Appeals Tribunal, May 9, 1996), the Tribunal, citing ***Matter of Standard Mfg. Co.*** (Tax Appeals Tribunal, February 6, 1992), opined that "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." Here petitioner has adduced sufficient evidence to show that its intercorporate transactions with Wilson FSC were arm's length.

Initially, it is noted that the foreign trading gross receipts figures reported by Wilson FSC on Schedule P, Transfer Price or Commission, of forms 1120-FSC represent the actual sales made by petitioner to its unrelated foreign-based customers. The record herein contains no proof, or allegation for that matter, that sales were made to related parties at less than fair market value. Clearly then, the foreign trading gross receipts figures as reported by Wilson FSC represent arm's-length transactions.

G. To compute combined taxable income from its foreign sales, petitioner attributed or allocated a portion of its cost of goods sold and other expenses to its foreign sales activities. Once again, the Division has submitted no proof or allegation that the costs allocated by

petitioner to its foreign sales activities were not accurate or representative of arm's-length prices. Accordingly, the combined taxable income amounts computed on forms 1120-FSC accurately portray the net profit generated from petitioner's foreign sales activities. In turn, a portion of the foreign net profit is permitted, by statute, to be allocated to Wilson FSC using the administrative pricing rules of IRC § 925 (a)(2), the 23% of combined taxable income method. Since the administrative pricing rules were designed to approximate arm's-length prices, thus creating a "safe harbor," and since there is no dispute that petitioner properly applied the administrative pricing rules in this matter, it follows that petitioner has successfully rebutted the presumption of distortion arising only from the existence of substantial intercorporate transactions.

H. Finally, when dealing with affiliated corporations, both the statute and regulations seek to assure that the proper income from New York sources and, as a consequence, the proper tax liability, is determined. This can be accomplished by separate returns or by permitting or requiring combined returns. The Division has assessed a tax due in this matter which averages $433.00 for each of the three years at issue. With such a *de minimis* amount of tax due in relation to the amount of tax reported as due by petitioner on its separate returns, it would appear that filing on a separate basis accomplished the goal sought by the law and regulations.

I. The petition of The H. W. Wilson Company, Inc. is granted and the Notice of Deficiency dated April 16, 2001 is canceled to the extent that it requires petitioner to file combined returns with Wilson, FSC. and is sustained with respect to any and all other adjustments reflected on the notice.

DATED: Troy, New York
April 15, 2004

/s/ James Hoefer
PRESIDING OFFICER