

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
IT USA, INC. :
for Redetermination of a Deficiency or for Refund :
of Corporation Franchise Tax under Article 9-A of :
the Tax Law for the Years 2002, 2003 and 2004. :

In the Matter of the Petition :
of :
MANIFATTURE ASSOCIATE :
CASHMERE USA, INC. :
for Redetermination of a Deficiency or for Refund :
of Corporation Franchise Tax under Article 9-A of :
the Tax Law for the Years 2002, 2003 and 2004. :

DECISION
DTA NOS. 823780
AND 823781

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on December 20, 2012. The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel). Petitioners appeared by Mayer Brown LLP (Alvan L. Bobrow, Esq. and Jeffrey S. Reed, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition. The Division of Taxation filed a brief in reply. Oral argument was heard on October 16, 2013 in Albany, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the

following decision.

ISSUE

Whether the Division of Taxation improperly required petitioners, IT USA, Inc. and Manifatture Associate Cashmere USA, Inc., and their parent corporation, IT Holding USA, Inc., to file separate corporation franchise tax reports for the years 2002, 2003 and 2004.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, except for findings of fact 8, 10, 15, 16, 17, 24, 27, 31, 33 and 43, which have been modified to more accurately reflect the record. We also make an additional finding of fact, numbered 44 herein. The Administrative Law Judges's findings of fact, the modified findings of fact and the additional fact are set forth below.

1. IT Holding SpA is an Italian clothing company based in Milan, Italy. Along with its subsidiaries, it operates a luxury goods clothing and apparel business that encompasses the design, production and distribution of fully-owned clothing and apparel labels such as Gianfranco Ferre. It also licenses labels, including Just Cavalli, Galliano, C'N'C Costume National and ERMANNO Scervino. IT Holding SpA distributes its clothing and apparel through third-party stores and directly-owned stores located in major fashion centers around the world.

2. IT Holding SpA's initial footprint in the United States was called Fashion Avenue, Inc. (Fashion Avenue). Fashion Avenue was formed in the 1990s to distribute IT Holding SpA brands throughout the United States. It was based in New York at the offices of its accountants, Funaro & Co. Fashion Avenue's business grew, and it was necessary for Fashion Avenue to begin hiring additional personnel in the United States. Eventually its name was changed to IT

USA, Inc. (IT USA). It was managed by Enrico DiMuccio.

3. As IT Holding SpA's business grew, its management sought strategic acquisition prospects. On or about March 5, 1999, IT Holding SpA acquired a clothing and apparel company based in Italy, called Manifatture Associate Cashmere SpA. Besides Italy, Manifatture Associate Cashmere SpA also operated in a number of different countries around the world, including the United States. Its operations in the United States were housed in Manifatture Associate Cashmere USA, Inc., (MAC), which was the company's American subsidiary.

4. Management at IT Holding SpA thought that it might be possible to expand further in the United States. They wanted to create a new corporation that would function as an intermediary between the Italian-based headquarters and the United States business. The new corporation would centralize all United States management and administrative functions and would eliminate any overlap of such functions among the United States businesses. The goal was to reduce overhead costs by eliminating separate management for the companies.

5. The new corporation that was formed to centralize United States management and administrative functions was called IT Holding USA, Inc. (IT Holding). It was incorporated during the last quarter of 2001. To clarify that IT USA and MAC were subordinate to IT Holding, the stock of IT USA and MAC was transferred to IT Holding on January 1, 2002. Enrico DiMuccio served as president of IT Holding, IT USA and MAC.

6. Prior to the creation of IT Holding, IT USA performed various administrative services for MAC, as well as for itself. These services included monitoring inventory, customs brokering, insurance, employee benefits, budgeting, human resources, public relations, credit, receivables, factoring, real estate and strategic planning. When IT Holding was created, the employees who

performed these services in IT USA were transferred to IT Holding.

7. IT Holding performed various services for IT USA and MAC. These services were generally performed from the company's commercial domicile, which was located at 85 Fifth Avenue in Manhattan. It was necessary for IT Holding to perform various services for IT USA and MAC because both subsidiaries only employed sales personnel and did not have their own independent management or administrative employees to perform logistical functions. For example, they were not equipped to order inventory from Italy and have it shipped to customers in the United States. Accordingly, they were reliant on IT Holding to manage their operations and their businesses. The necessary day-to-day functions performed for IT USA and MAC by IT Holding included the ordering, shipping and tracking of inventory, performing credit checks, collection activity and advertising and public relations.

8. IT Holding had no inventory of its own and its activities were limited to handling management, corporate, administrative and logistical services for related corporations. It employed approximately 12 to 14 individuals.

9. IT Holding had a shipping and logistics department that processed orders for customers of IT USA and MAC. Typically, customers would examine IT USA or MAC clothing or apparel in a showroom and would place a bulk order. IT Holding's shipping and logistics department would process the order. This encompassed first arranging for inventory to be shipped from Italy to fill the order, and then shipping the inventory from Italy to the United States. IT Holding contracted with a distribution company and a customs broker to facilitate such overseas shipments.

10. IT Holding used sophisticated software to track shipments and orders (e.g., orders of

clothing and apparel from IT USA and MAC). The software also enabled IT Holding to monitor outstanding receivables from customers of IT USA and MAC. The software was licensed from an unrelated third party. IT Holding paid the unrelated third party for the software license.

11. IT Holding had a financial controls department that handled insurance and workers compensation policies for IT USA and MAC salespeople. The same department also arranged for medical and dental plans for the IT USA and MAC salespeople.

12. IT Holding had a human resources department that was responsible for the hiring and firing of employees, including the salespeople employed by IT USA and MAC.

13. IT Holding had a public relations department that was responsible for public relations for related companies, including public relations with respect to IT USA and MAC. The public relations department also handled advertising for IT USA and MAC. At times, an invoice from a third-party firm would be issued to IT USA for advertising services, which IT USA would pay directly to the advertising firm.

14. IT Holding had a credit department that was responsible for determining whether receivables should be factored and whether customers should be permitted to make purchases using credit. The credit department was also responsible for sending out invoices and collecting receivables.

15. IT Holding rented a warehouse located in New Jersey to store IT USA and MAC merchandise that was damaged in shipping or that could not be sent to a purchaser because there was a credit hold.

16. IT Holding organized fashion shows to display the luxury clothing and apparel of IT USA and MAC.

17. There was no written management services agreement between IT Holding and petitioners. There were also no written management services agreements between IT Holding and other related companies doing business in the United States for whom IT Holding provided similar services. As shown by the consolidated financial statements in the record, during the period at issue, the management fees earned by IT Holding were based on IT Holding's cost of operations with no markups. Such cost of operations consisted of general and administrative expenses, including salaries and rent, and selling expenses, including trade shows and exhibitions. The management fees, i.e., IT Holding's cost of operations, were allocated to petitioners and the other related companies by estimating the number of hours IT Holding employees committed to each corporation. IT Holding employees did not maintain records of the number of hours spent on each corporation. No explanation was provided as to the methodology used to estimate such hours. Petitioners submitted a management fee schedule to document the compensation IT Holding should receive for the services it performed for IT USA, MAC and other related companies for 2002. No source documentation was provided to support the allocated amounts on the management fee schedule.

18. It was intended that IT Holding would recognize no gain or loss for tax and financial accounting performances, but would rather perform the various management services and administrative services as described and be reimbursed at cost. IT Holding received management fee income from entities outside the combined group for similar services, and also paid management fees to entities not part of the combined group. The financial statements reflect that there was no net income in IT Holding's books.

19. IT USA was incorporated in 1996. It sold luxury Italian clothing and apparel, and

specialized in the wholesale distribution of women's clothing.

20. All of IT USA's stock was owned by IT Holding.

21. During the period at issue, IT USA had no employees of its own other than salespeople. All orders of its clothing during the audit period were processed by IT Holding. IT USA made no purchases of clothing and related apparel from either IT Holding or MAC. All purchases of clothing and related apparel were made from entities not included in the combined returns.

22. MAC sold luxury Italian clothing and apparel, specializing in the wholesale and retail distribution of cashmere and related apparel. MAC and all its assets were acquired by IT Holding SpA when IT Holding SpA acquired MAC's Italian parent company.

23. One of the assets that was acquired in the transaction was a co-op located at 85 Fifth Avenue in Manhattan.

24. While MAC owned the co-op, it did not formally lease or sublease the co-op to IT Holding or other related companies, including IT USA, that occupied the co-op. In other words, there were no formal rental agreements between MAC and such other entities. The consolidated financial statements report rental expenses for IT USA and IT Holding for the use of the space at the co-op, as well as the corresponding rental income to MAC.

25. MAC had a showroom at the co-op that was used to display its clothing and apparel to prospective buyers. Potential customers would view this sample clothing and apparel in the showroom and would then decide whether to order in bulk based on examining the samples.

26. While MAC owned the showroom, there were no leases or subleases to other companies that also displayed clothing at the showroom.

27. MAC continually had a negative cash flow and received money from IT USA to stay solvent and to fund its operations. The consolidated financial statements indicate that the principal balance on loans from IT USA to MAC was \$2,950,000 in 2002, \$3,850,000 in 2003, and \$3,013,000 in 2004. The principal balance on the loans thus decreased by \$837,000 between 2003 and 2004. No formal notes or other indicia of indebtedness were ever created to memorialize this transfer of funds. Interest on the loans accrued at a rate of 6.5% for financial accounting purposes, and MAC reported interest expense from the loans on its pro forma federal income tax returns for each of the years at issue.

28. All of MAC's stock was owned by IT Holding.

29. MAC had no employees of its own other than salespeople. All orders of its clothing during the audit period were processed by IT Holding. MAC made no purchases of clothing and related apparel from either IT Holding or IT USA. All purchases of clothing and related apparel were made from entities not included in the combined returns.

30. As previously mentioned, Enrico DiMuccio was the president of IT Holding, IT USA and MAC. His responsibilities included overseeing all aspects of all of IT Holding's departments, and he was in total and sole control of the operations of IT USA and MAC, including making all of the sales decisions. Mr. DiMuccio was the sole representative of the Italian parent company in the United States.

31. IT Holding, IT USA and MAC had their own checking accounts. However, the checking accounts were linked online. Mr. DiMuccio had authority to transfer cash between the checking accounts and to move funds freely between the companies. He did not need any further authorization before making these transfers between the companies, but rather could transfer

funds between the companies at his discretion.

32. Fashion Avenue, later IT USA, initially operated from the offices of Funaro & Co., Inc. IT USA engaged Funaro & Co., Inc., to produce mid-year and annual financial statements for the company, prepare its tax returns and verify the third-party expenses appearing on the management fee schedule.

33. Beginning in the year 2000 through the years at issue, the director of audit services for Funaro & Co., Inc., worked with Fashion Avenue and then IT USA, assisting in the preparation of the financial statements for the company. According to the director, financial accounting rules require that a disclosure statement be placed in financial statements when a company is “economically dependent” on another company. In its certified consolidated financial statements prepared for IT Holding and subsidiaries IT USA and MAC, a disclosure was inserted to note that IT Holding, IT USA, and MAC were economically dependent on related parties that were not part of the consolidated group. The financial statements were prepared so that all significant inter-company investments, advances, transactions and profits were eliminated. The financial statements reflect that IT Holding was allocated management fees from IT USA and MAC to pay for IT Holding’s “general and administrative expenses” and “selling expenses” and that, after an adjustment for depreciation, IT Holding was in a break even position.

34. Funaro & Co. prepared a combined New York Franchise Tax Report for IT Holding, IT USA and MAC for the 2002, 2003 and 2004 years. On IT USA’s and MAC’s pro forma federal income tax returns, the entities reported numerous expenses in the “other deduction” category, such as consulting management fees, accounting and auditing fees, legal fees, bank

charges, collection fees, freight fees, selling expenses, commissions and royalties. Prior to the tax year 2002, IT USA and MAC filed separate returns in New York State.

35. Following an audit of the combined reports filed by IT Holding, IT USA and MAC for the tax years 2002, 2003 and 2004, the Division of Taxation (Division) determined that the members of the combined group should be filing on a separate basis. The Division assessed the corporations as if they had filed separate entity reports.

36. During the course of the audit, the Division requested documentation to support petitioners' combined filings. The Division received a one-page schedule entitled "Management Fees" for the year 2004. The schedule listed several companies, including IT USA and MAC, with percentages and dollar amounts. The schedule itself does not establish that IT USA or MAC meet the 50% threshold of the substantial intercorporate transaction requirement.

37. In an attempt to verify the percentages included on the schedule, the Division requested a copy of the management agreement between petitioners, as well as a numerical analysis of how the management fees were computed (including a reconciliation to the tax returns) and any pricing study for the management services IT Holding provided to IT USA and MAC. The Division was informed that no management agreement existed between petitioners.

38. By letter dated November 21, 2007, petitioners provided a written description of the business activities and business relationship of IT Holding, IT USA and MAC in support of their combined filings.

39. By letter dated December 28, 2007, the Division requested support for petitioners' statements in their letter of November 21, 2007. The letter provided as follows:

During our phone conference on September 27, 2007, we had requested from you

a quantitative analysis of the inter-company transactions between the members of the NYS as-filed combined group. Review of your correspondence, received November 28, 2007 fails to provide such analysis. In order for us to properly ascertain if the third requirement [sic]:

Distortion Requirement-where 50% or more of the corporation's activities, income, expenses or capital are with another member of the group or with a combined or combinable group of corporations, you need to provide the following:

- A. All Inter-company activity between IT USA and IT Holding
- B. All Inter-company activity between MAC and IT Holding
- C. All Inter-company activity between MAC and IT USA

Please note that the information requested above, must be supported by a numerical analysis and reconciled to the Federal 1120 returns filed. It also should be noted that in order to meet the 50% threshold, you must show how A, B, and C above, separately meet this requirement. Your computation **should not** reflect the combined activities of any one member with that of another member to satisfy the 50% test for the third member.

Example: Affiliate A + Affiliate B activities combined can't satisfy the 50% test for Affiliate C (not acceptable).

The activity quantified has to be **between the two** companies, not **among the three** companies (Emphasis in original).

40. The Division sent a follow-up letter dated June 10, 2008 to petitioners' new representatives. Despite numerous requests, the Division did not receive any documentation to substantiate the statements included in petitioners' November 21, 2007 letter.

41. Based on the lack of adequate documentation, as well as the information contained in petitioners' tax returns, the Division determined that petitioners did not meet the substantial intercorporate transaction requirement and further determined that petitioners should have filed on a separate basis, so as to correctly reflect their income in New York.

42. Petitioners, IT USA and MAC, executed seven consents extending the period of

limitations for assessment of corporation franchise tax under Article 9-A of the Tax Law that collectively extended to December 31, 2009 the period in which to assess corporation franchise tax due for the years 2002, 2003 and 2004.

43. On May 28, 2009, the Division issued a Notice of Deficiency to IT USA, assessing corporation franchise tax in the amount of \$442,826.00, plus penalty and interest, for the years 2002 through 2004. On June 8, 2009, the Division issued a Notice of Deficiency to MAC, assessing corporation franchise tax in the amount of \$40,497.00, plus penalty and interest, for the years 2002 through 2004. Both notices of deficiency were sustained by Bureau of Conciliation and Mediation Services conciliation orders, dated May 7, 2010.

44. At the hearing, petitioners presented the testimony of two witnesses to describe the business activities and business relationships of the three corporations involved in this matter. Petitioners' first witness, the financial controller at IT Holding, began his employment with IT Holding in June 2005. He was not employed by IT Holding or petitioners during the period at issue. Petitioners' second witness, the director of audit services for the accounting firm engaged by petitioners and IT Holding, has been employed by that firm since June 2000 and was involved with the preparation of financial statements for petitioners and IT Holding throughout the period at issue.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge first reviewed the statutory and regulatory standards for the filing of combined reports for corporation franchise tax as in effect during the period at issue. Pursuant to such standards, combined filers must meet certain requirements regarding capital stock ownership, engagement in a unitary business, and distortion resulting from separate filings.

The Administrative Law Judge noted that the capital stock requirement was not at issue in the present matter. The Administrative Law Judge found that IT Holding and petitioners were engaged in a unitary business during the years at issue. He cited the provision of management, corporate, administrative and logistical services by IT Holding to petitioners, the cash management system, and the loans from IT USA to MAC as indicative of the unitary business.

The Administrative Law Judge also found that petitioners met the distortion requirement. He cited the cash management system's benefit to MAC of avoiding the need for financing from unrelated third party lenders; the loans from IT USA to MAC, which the Administrative Law Judge determined were unreimbursed; the provision of management, corporate, administrative and logistical services by IT Holdings for petitioners, including costs for warehousing and fashion shows, all of which the Administrative Law Judge determined were unreimbursed; and IT Holding and IT USA's use of office and showroom space in the co-op without, according to the Administrative Law Judge, compensating MAC as factors contributing to this conclusion. Having met the required tests, the Administrative Law Judge concluded that petitioners and IT Holding properly filed their corporation franchise tax returns on a combined basis during the years at issue.

The Administrative Law Judge specifically grounded his factual findings and resulting legal conclusions on the "credible testimony of two witnesses" who "described in detail the business activities and business relationship of the three corporations involved herein."

Accordingly, the Administrative Law Judge granted the petitions and canceled the notices of deficiency.

ARGUMENTS ON EXCEPTION

The Division argues that petitioners have not met their burden of proving either a unitary business or the existence of distortion with respect to any of the factors determined by the Administrative Law Judge to contribute to such findings. Noting the determination's reliance on witness testimony, the Division asserts that this Tribunal is not bound by the Administrative Law Judge's evaluation of witness credibility. The Division asserts that such testimony is contradicted by petitioners' pro forma federal income tax returns and consolidated financial statements. According to the Division, such documents accurately portray petitioners' income and finances during the years at issue, and show that separate filing is proper.

With respect to the cash management system, the Division seeks to distinguish the record in the present matter from the facts in *Matter of Heidelberg Eastern, Inc.* (Tax Appeals Tribunal, May 5, 1994), cited in the determination, where a central cash management system was determined to benefit the members of a combined group. The Division contends that the record in this matter lacks sufficient detail to show how the cash management system operated and thereby show the extent to which petitioners benefitted from the system.

The Division notes that the Administrative Law Judge's findings regarding the operation of the cash management system relied exclusively on witness testimony. More specifically, such findings rested primarily on the testimony of a witness who was not employed by either petitioner or IT Holding during the period at issue. The Division asserts that the testimony presented lacked the necessary specificity to conclude that the cash management system was indicative of a unitary business or resulted in distortion. The Division further notes that the individual in apparent control of the cash management system, Mr. DiMuccio, did not testify at

the hearing.

With respect to the Administrative Law Judge's finding that loans from IT USA to MAC resulted in distortion, the Division asserts that MAC's pro forma federal income tax returns report interest expense with respect to such loans and that petitioners' consolidated financial statements indicate that MAC repaid \$837,000 in principal on loans it received from IT USA in 2004. The Division asserts that such evidence compels the rejection of any testimony in the record to the contrary. Again seeking to distinguish *Heidelberg Eastern*, the Division contends that the record contains no evidence to show that MAC either could not have obtained such financing as it received from IT USA, or that it would have had to pay a higher interest rate if it had borrowed from an unrelated third party.

With respect to petitioners' payment of management fees to IT Holding, the Division notes that petitioners' pro forma federal income tax returns and consolidated financial statements both indicate the payment of such fees. The Division asserts that this is a proper reflection of the arrangement and that it does not indicate distortion.

The Division also asserts that IT Holding was reimbursed for the warehouse rental through management fees. Additionally, the Division argues that the Administrative Law Judge's finding, based solely on testimony, that IT Holding was not reimbursed for organizing fashion shows that cost, on average, \$500,000 to \$600,000, is inconsistent with the consolidated financial statements and pro forma tax returns that show expenses for trade shows and exhibitions of a substantially lesser amount.

As a general point, the Division argues that it is inconsistent to find that IT Holding had unreimbursed expenses, but that it had no net income and recognized neither gain nor loss.

The Division also contends that the Administrative Law Judge's finding that IT Holding and IT USA did not pay rent to MAC for use of its co-op space is inconsistent with IT USA's pro forma returns reporting rental expense. The Division further asserts that it is unclear how petitioners use the co-op space because they also lease space from an entity not included in the combined group. The Division thus contends that the use of the co-op space should not be a factor in the unitary business and distortion analysis.

Accordingly, the Division requests that the determination be reversed and the notices of deficiency sustained.

Petitioners contend that they and IT Holding were engaged in a unitary business under the standards set forth in the Division's regulations (*see* 20 NYCRR 6-2.2 [b]) and under federal constitutional standards.

Petitioners also contend that they have shown that separate reporting of their corporation franchise tax returns would result in distortion for the years at issue. Petitioners assert that the cash management system did not operate on an arm's length basis and thus produced distortion. Petitioners assert that MAC benefitted from this system because the system enabled MAC to meet its cash flow needs without having to borrow from unrelated third parties, and MAC did not pay for this benefit. Petitioners further assert, contrary to the Division's contention, that they presented sufficient evidence to establish their claim that the cash management system was distortive.

Additionally, petitioners argue that the loans from IT USA to MAC were distortive. Petitioners note the absence of any documentation of the loans, including the absence of any documentation of an agreed interest rate, payback period or maturity date, and suggest that such

an arrangement is inconsistent with an arm's length transaction. Petitioners reject the Division's argument that the accrual of interest with respect to the loans, as reflected on the pro forma tax returns and consolidated financial statements, shows that the loans were not distortive because MAC neither actually paid any interest, nor fully paid down the balance. Petitioners also contend that the lack of any demands for repayment, the lack of any regular or periodic payments, and the lack of a maturity date support a finding that the terms of the loans were less than arm's length and thus distortive. Petitioners further assert that the money that was used to pay down the loans came from the cash management system, which, as noted, consisted of shared money. Petitioners contend that MAC benefitted from the loans from IT USA because MAC consistently operated at a loss during the period at issue, and needed funding to continue its operations. Petitioners assert a further benefit to MAC from the terms of the loans, or lack thereof, with respect to repayment as noted. As a consequence of the loans from IT USA, petitioners contend that MAC did not have to seek financing from an unrelated third party at arm's length terms.

Petitioners also argue that the wide array of administrative and support services provided by IT Holding to petitioners was distortive. Petitioners note that they could not have operated their businesses without the support of IT Holding personnel. Petitioners further note that no written intercompany services agreement was ever created. Fees were estimated based on the total compensation paid to IT Holding employees and, therefore, were designed to charge for services at cost. Petitioners assert that in an uncontrolled transaction, the party providing services would charge a mark-up. Petitioners further maintain that the management fees were never actually paid.

Petitioners also find distortion in the asserted non-reimbursed payment by IT Holding on

behalf of petitioners for fashion shows and warehouse space. Additionally, petitioners assert that IT USA and IT Holding's use of the co-op space owned by MAC without any lease agreement and without charging rent is also distortive.

Accordingly, petitioners request that the determination be affirmed.

OPINION

We affirm the determination of the Administrative Law Judge for the reasons stated herein.

Preliminarily, and as a point of procedure, we note that petitioners proposed certain "modifications" to the Administrative Law Judge's findings of fact in their brief. Petitioners did not file an exception to the determination, however, and therefore may not request such alternative findings of fact (*see* 20 NYCRR 3000.17; *see also Matter of Klein's Bailey Foods, Inc.*, Tax Appeals Tribunal, August 4, 1988 [cross-exceptions not permitted under the Rules of Practice and Procedure]).

Turning to the main issue, while, generally, "[e]very corporation is a separate taxable entity and shall file its own report" (20 NYCRR 6-2.1), during the period at issue, reporting on a combined basis with one or more other corporations, as authorized pursuant to Tax Law § 211 (former [4] [a]), was required or permitted under certain circumstances. Specifically, combined reporting was required or permitted where the corporations in the group met the capital stock requirement (20 NYCRR 6-2.2 [a]), the unitary business requirement (20 NYCRR former 6-2.2 [b]) and the "other" or "distortion" requirement (20 NYCRR former 6-2.3) set forth in the regulations (*see* 20 NYCRR former 6-2.1).

There is no dispute in the present matter that the capital stock requirement has been met,

as petitioners were wholly-owned subsidiaries of IT Holding during the period at issue (*see* 20 NYCRR 6-2.2 [a]).

As to whether the members of the proposed combined group were engaged in a unitary business, the Division's regulations provide for a review of the following considerations in making such a determination: (1) whether the activities in which the corporation engages are related to the activities of the other corporations in the group; and (2) whether the corporation is engaged in the same or related lines of business as the other corporations in the group (*see* 20 NYCRR former 6-2.2 [b]; 20 NYCRR 6-2.3 [e]). Additionally, the Supreme Court has developed certain unitary business indicia rooted in federal constitutional law (*see Allied-Signal v Director, Div. of Taxation*, 504 US 768 [1992]). Such indicia are properly considered in analyzing unitary business issues arising under Article 9-A (*see Heidelberg Eastern*) and are in harmony with the Division's unitary business regulations (*see Matter of USV Pharmaceutical Corp.*, Tax Appeals Tribunal, July 16, 1992). We have summarized the Supreme Court's unitary business criteria as follows:

“The constitutional prerequisite to an acceptable finding of unitary business is a flow of value between the subject entities (*Container Corp. of Am. v. Franchise Tax Bd.*, 463 US 159, 178, *reh denied* 464 US 909). The Supreme Court has further stated that while the indicia of a unitary business are functional integration, centralization of management and economies of scale, there is no single test for determining whether a unitary business exists; rather, there are a wide range of constitutionally acceptable variations of the unitary business theme (*Container Corp. of Am. v. Franchise Tax Bd., supra*)” (*Matter of Medtronic, Inc.*, Tax Appeals Tribunal, September 23, 1993).

We agree with the Administrative Law Judge that petitioners and IT Holding were engaged in a unitary business. As the Administrative Law Judge noted, petitioners and IT Holding were all engaged in the same or related lines of business, as petitioners sold Italian

clothing and apparel and IT Holding serviced and managed corporations selling Italian clothing and apparel. Additionally, IT Holding's activities were related to the activities of petitioners because its primary business activity was providing services to petitioners. Moreover, such services were essential to petitioners' business activity of selling Italian clothing and apparel. Petitioners thus meet the regulatory criteria for a unitary business.

In terms of the federal constitutional requirements, the three corporations operated as functionally integrated wholesalers of imported Italian clothing and apparel. They had a common president; centralized management and administrative support with respect to the ordering, shipment and tracking of inventory, credit checks, collection activity, advertising, public relations, and human resources; and a cash management system through which the common president of all three entities had the authority to move funds between the corporations as needed. These facts demonstrate a sufficient flow of value between and among the three corporations to satisfy the federal constitutional standard for a unitary business (*see Heidelberg Eastern*).

The final requirement to permit or require the filing of combined reports is a showing of distortion. During the period at issue, where, as here, there is no claim of "substantial intercorporate transactions" among the corporations, the distortion requirement is satisfied if "the filing of a report on a separate basis . . . results in a distortion of such taxpayer's activities, business, income or capital . . ." (20 former NYCRR 6-2.3[d]). As the party seeking combination, petitioners bear the burden of proving distortion (*see Matter of Mohasco Corp.*, Tax Appeals Tribunal, November 10, 1994) and may do so by establishing that transactions between petitioners and IT Holding were not priced at arm's length (*see Matter of Kellwood Co.*,

Tax Appeals Tribunal, September 22, 2011). As stated in *Matter of Standard Mfg. Co. v Tax Commn. of State of N.Y.* (114 AD2d 138 [1986], *affd* 69 NY2d 635 [1986]):

“[T]he ultimate question of whether, under all of the circumstances of the intercompany relationship . . . combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income. In answering this question, no single factor is decisive (*Matter of Coleco Inds. v. State Tax Comm.*, 92 AD2d 1008, 1009).”

As the Administrative Law Judge correctly noted, the concepts of unitary business and distortion are related, such that the same factors that indicate a unitary business may also give rise to or cause distortion of income (*see Heidelberg Eastern*). It is not enough, however, to point to the same factors that demonstrate a unitary business to establish distortion, for such an analysis:

“merely identif[ies] possible areas of distortion. [Petitioners] must, as a minimum, identify with particularity the activities or transactions which [they claim] give rise to distortion and explain how distortion arises from those activities or transactions” (*Matter of Silver King Broadcasting of N.J.*, Tax Appeals Tribunal, May 9, 1996).

We find that IT Holding’s provision of management, corporate, administrative and logistical services, as described herein, to petitioners at cost resulted in distortion. The record clearly shows that petitioners, with only sales personnel in their employ, could not have operated without the wide array of support services provided by IT Holding (*see* Findings of Fact 7-16, 31). The record also shows that the management fees charged by IT Holding in consideration of such services were premised solely on IT Holding’s cost of operations and were thus provided at cost (*see* Findings of Fact 17 and 18). In *Matter of Mohasco Corp.*, we held that the lack of a markup on transactions between a parent and subsidiary resulted in distortion. The charge to the subsidiary in *Mohasco* was an estimated allocation of the parent’s cost of operations and

included various expenditures made in support of the subsidiary's operations. Similarly, the management fees charged to petitioners amount to an estimated allocation of costs incurred by IT Holding in support of petitioners' sales operations. Accordingly, consistent with our holding in *Mohasco*, the lack of a markup on the management fees resulted in distortion herein.

The Division contends that distortion is not evident as a result of the services because IT Holding was fully reimbursed for its costs. We have long held, however, that controlled transactions must be on arm's length terms to avoid distortion and that arm's length normally means a markup over cost (*see e.g., Matter of USV Pharmaceutical Corp.*). Indeed, in *Mohasco*, we specifically found that the allocation of the corporate parent's cost "for services acquired on behalf of, and rendered to and for subsidiaries" was distortive. The circumstances in the instant matter are substantially similar. We thus reject the Division's contention.

As petitioners have met the capital stock, unitary business and distortion requirements, we conclude that petitioners and IT Holding properly filed their corporation franchise tax reports on a combined basis pursuant to Tax Law § 211 former (4) (a) and 20 NYCRR former 6-2.1 for the years at issue. Consequently, we further conclude that the Division improperly recomputed petitioners' franchise tax liabilities for those years to reflect separate filings.

Although we reach the foregoing conclusions, we note our disagreement with certain aspects of the Administrative Law Judge's determination.

First, we disagree with the Administrative Law Judge's findings that petitioners never paid any management fees to IT Holding; that MAC did not pay any interest or principal on the loans from IT USA; and that neither IT USA nor IT Holding paid rent to MAC for the use of the co-op. Petitioners contend that, while the subject transactions were recorded and accrued for tax

purposes, they were never “actually paid.” That is, according to petitioners, funds were never transferred in respect of any of these transactions. Under the circumstances, however, transfers of cash between the companies were of little consequence. Specifically, under the cash management system by which petitioners and IT Holding operated, the common president of the three companies was in charge of all accounts and had the authority and discretion to transfer funds between accounts as he deemed appropriate. Petitioners’ argument thus devolves to an assertion that the failure to transfer funds from one shared account to another shared account constitutes nonpayment. Indeed, petitioners’ representative laid bare the insignificance of “actual payment” between the companies by his description of the cash management system at oral argument: “[I]t is almost as if there is one pot of money, and the money can be shared among the companies” (tr at 18). Furthermore, we have previously accepted the posting of payments to intercompany accounts as sufficient evidence of payment in the context of controlled intercorporate transactions (*see Silver King Broadcasting of N.J.*). Here, all of the intercorporate transactions were recorded in petitioners’ and IT Holding’s books and records, and were reflected in the companies’ consolidated financial statements and pro forma tax returns. We thus find that the intercorporate transactions described herein were paid for purposes of determining distortion.

We also take issue with the Administrative Law Judge’s finding that petitioners proved that the cash management system resulted in distortion. First, as the management fees were premised on IT Holding’s total cost of operations, then, logically, such fees would include all costs incurred by IT Holding to perform the cash management system function. Second, as to any economic benefit to petitioners resulting from the availability of funds through the cash

management system, as the Division noted in its brief, the Administrative Law Judge's finding was premised solely on the testimony of petitioners' witnesses. The financial controller who testified was not employed by IT Holding until after the audit period. As such, he was not in a position to know (and was not specifically questioned as to how) the cash management system functioned during the audit period. His testimony thus lacked the "requisite competency" to provide a basis for concluding that the cash management system resulted in distortion during the period at issue (*see Matter of Impath, Inc.*, Tax Appeals Tribunal, January 8, 2004). Petitioners' second witness was employed by the accounting firm that prepared petitioners' and IT Holdings' certified financial statements and was involved in the preparation of such statements. He was thus in a position to know about the companies' finances and Mr. DiMuccio's authority to move funds between companies. His testimony was, therefore, sufficiently competent and credible to establish that such a cash management system existed during the period at issue. As noted previously, the existence of the cash management system is indicative of a unitary business and is therefore a "possible area of distortion" (*see Matter of Silver King Broadcasting of N.J.*). As also noted previously, however, to actually prove that the cash management system caused distortion, petitioners were required to "identify with particularity the activities or transactions which [they claim] give rise to distortion and explain how distortion arises from those activities or transactions" (*id.*). In the context of the cash management system described herein, this meant presenting evidence of the frequency of transfers and the amount of funds transferred, and thereby showing how the system benefitted petitioners (*see Heidelberg Eastern*). This witness did not testify as to any specific transfers or that he reviewed records of any transfers. His testimony is thus insufficient to prove that the cash management system caused distortion.

We further take issue with the Administrative Law Judge's factual findings that IT Holding was not reimbursed for any expenses it incurred with respect to warehouse rental or fashion shows. As noted, the management fees were premised on IT Holding's total cost of operations. Such cost of operations necessarily included any expenditures by IT Holding for warehouse rental and fashion shows.

We also disagree with the Administrative Law Judge's finding that the loans between IT USA and MAC resulted in distortion. Specifically, as discussed previously, we find that interest on the loans was paid for purposes of our distortion analysis. Second, contrary to the Administrative Law Judge's finding that there was no stated interest rate on the loans, the record shows that interest on the loans was 6.5%, and petitioners offered no evidence to show that such rate was not arm's length. We also find that petitioners have not proven the absence of any repayment schedule for the loans, considering that MAC reduced the principal on the loans by \$837,000 between 2003 and 2004. We note that petitioners conceded this reduction in loan principal in their brief on exception.

Finally, we note our disagreement with the Administrative Law Judge's finding that distortion resulted from IT Holding and IT USA's purported failure to pay MAC for their use of MAC's co-op. As discussed previously, rent on the space was paid for purposes of determining distortion. Petitioners did not argue that the amount of the rental was non-arm's length.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petitions of IT USA, Inc. and Maniffature Associate Cashmere USA, Inc. are

granted; and

4. The notices of deficiency, dated May 28, 2009 and June 8, 2009, are canceled.

DATED: Albany, New York
April 16, 2014

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner