STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petitions	:	
of	:	
KNOWLEDGE LEARNING CORPORATION AND KINDERCARE LEARNING CENTERS, INC.	:	DECISION DTA NOS. 823962 and 823963
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Periods ended December 31, 2005, December 30, 2006 and December 29, 2007.	:	

Petitioners, Knowledge Learning Corporation and Kindercare Learning Centers, Inc., filed an exception to the determination of the Administrative Law Judge issued on June 27, 2013. Petitioners appeared by WTAS LLC (Kenneth T. Zemsky, CPA, and Raymond J. Freda, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a brief in reply. Oral argument was heard on March 19, 2014, in New York, New York.

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

ISSUES

I. Whether, during the 2007 tax year, substantial intercorporate transactions existed between petitioners, Knowledge Learning Corporation and Kindercare Learning Centers, Inc., and between Knowledge Learning Corporation and the other members of the proposed combined group, thereby requiring the filing of a combined report for that year pursuant to Tax Law § 211 (4) (a).

II. If not, whether combined reports for the 2007 tax year must be permitted based on a showing that separate reporting results in distortion, and whether petitioners have proven that such distortion exists in the present matter.

III. Whether, with respect to the computation of petitioners' Metropolitan Commuter Transportation District surcharge for the years at issue, the Division of Taxation properly estimated petitioners' reported Metropolitan Commuter Transportation District allocation percentage.

IV. Whether petitioner Kindercare Learning Centers, Inc., has established entitlement to a net operating loss deduction.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, except for findings of fact 4, 5, 8-11, 13, 15, 18-22, 24, 27 and 28, which we have modified. We also make additional findings of fact, numbered 31 through 39 herein. We make these changes to more accurately reflect the record. The Administrative Law Judges's findings of fact, the modified findings of fact and the additional facts are set forth below.

1. Knowledge Learning Corporation (KLC) was incorporated in 1986 and began doing business in New York in 1994. KLC operates pre-K learning centers and after-school care for children ages six weeks to twelve years. During the audit years, KLC operated between 11 and 19 child care centers in New York.

2. Kindercare Learning Centers, Inc. (Kindercare) was incorporated in 1986 and began doing business in New York in 1988. Kindercare operates child day care centers and before and after-school programs for children ages six months to twelve years. Kindercare operated nine centers in New York, six of which were located in the Metropolitan Commuter Transportation District (MCTD).

3. KLC purchased Kindercare in January of 2005.

4. For the tax periods ended December 31, 2005 and December 30, 2006, petitioners, both 52-53 week year-end filers, filed separate franchise tax returns in New York.

5. For the tax period ended December 29, 2007, KLC filed a combined franchise tax return with Kindercare and certain other affiliates, including Mulberry Child Care Centers, Inc. (Mulberry).

6. The Division of Taxation (Division) conducted an audit of petitioners' separate filings for the tax periods ended December 31, 2005 and December 30, 2006 and petitioners' combined filing for the tax period ended December 29, 2007. After the 2007 returns were filed, KLC was notified by the Division that it would be auditing the taxable years 2005, 2006 and 2007.

7. The audit commenced with a trip to KLC's offices on July 16, 2009. Three days later, the audit team held an exit conference with petitioner and notified KLC that the combined filing for 2007 appeared to be in error and would likely not be accepted by the Division. At the conclusion of the exit conference, the auditor gave KLC an information document request (IDR 1). IDR 1 requested information to substantiate that the requirements were met in order for the combined report to be accepted, including copies of any intercompany agreements or arrangements, a detailed explanation of all intercompany transactions, detail of income and

expense accounts for all intercompany transactions, and journal entries for all intercompany transactions.

8. In response to a request in IDR 1 for "a copy of all intercompany agreements/arrangements between KLC and any other affiliates included [in the 2007 combined return]," petitioners advised the Division that they did not memorialize any of the intercompany agreements with formal contracts.

9. Also in response to IDR 1, under the heading "Company Relationships," petitioners described their cash transactions as follows:

> In the wake of the KinderCare acquisition, cash has been concentrated at Knowledge Learning Corporation; modest balances appear on the trial balances of subsidiaries but these amounts are swept to the parent's account. This was achieved January 1, 2006 (footnote omitted). As a result, receipts of the subsidiaries post through the companies' intercompany accounts. All payments of expenses for all legal entities are paid by Knowledge Learning Corporation.

10. Petitioners provided spreadsheets, also in response to IDR 1, claiming to detail the intercompany transactions between KLC and its affiliates, including Kindercare. The spreadsheets contain separate columns for "Form 1120 Deduction," "Shared Service Allocation," and "Total Costs Purchased Through Knowledge Learning Corp."

"Form 1120 Deduction" refers to deductions in various categories as reported on pro forma separate federal returns for the 2007 tax year for KLC's affiliates. According to petitioners, such expenses constitute intercorporate transactions among the affiliates and KLC. "Shared Service Allocation" refers to the affiliates' cost for "back office" services, such as accounting, legal and personnel, provided by KLC. Petitioners concede that such services are not considered intercorporate transactions for purposes of determining whether "substantial intercorporate transactions" exist herein. "Total Costs Purchased Through Knowledge Learning Corp." is simply the sum of the other two categories.

For the tax period ended December 29, 2007, Kindercare showed a total of $588,514,844.00 under "Form 1120 Deduction;" a total of $66,829,978.00 under "Shared Service Allocation;" and a total of $655,344,822.00 under "Total Costs Purchased Through Knowledge Learning Corp."

For the tax period ended December 29, 2007, Mulberry showed a total of $45,366,096.00 under "Form 1120 Deduction;" a total of $335,941.00 under "Shared Service Allocation;" and a total of $45,702,037.00 under "Total Costs Purchased Through Knowledge Learning Corp."

The foregoing totals are consistent with deduction amounts attributable to Kindercare and Mulberry as reported on detail statements attached to petitioners' consolidated U.S. corporation income tax return for the same period. The totals designated as "Shared Service Allocation" on petitioners' spreadsheets is denoted "Overhead Allocation" on the relevant detail statement. The Division did not contest the amount of the various expenditures reported on the return or listed on the spreadsheets.

For purposes of determining whether they met the 50% substantial intercorporate transactions test, petitioners calculated the ratio of the totals under "Form 1120 Deduction" to the total deductions claimed on their federal returns. Kindercare's total expenses as indicated on its pro forma federal return for the 2007 tax year were $948,388,947.00.[1] Mulberry's total expenses as indicated on its pro forma federal return for the 2007 tax year were $67,524,622.00.

[1] Petitioners' spreadsheets incorrectly list $897,892,023.00 as Kindercare's total expenses.

11. Petitioners provided a disc containing more than 1.8 million lines of activity posting to intercompany accounts for the month of April 2007. Under the heading "Intercompany transaction journal entries," the IDR 1 response states that all cash accounts for all activities are concentrated in KLC's name. Every time that a cash transaction is posted for a subsidiary, an intercompany journal entry is recorded. The IDR 1 response sets forth certain examples of how this is accomplished.

12. Based upon petitioners' explanation of the cash transactions, intercompany transactions, and intercompany journal entries, the Division determined that KLC paid Kindercare's expenses with Kindercare's cash.

13. For the tax period ended December 29, 2007, KLC reported a $57.6 million loss for federal income tax purposes on an as-if separately filed basis. Kindercare's pro forma separate federal filing for the same period reports $109.3 million of income. As determined by the Division on audit, the proposed 2007 combined filing effectively used KLC's loss to offset a part of Kindercare's income, to the extent that such loss and such income are allocable to New York.[2]

14. Based on the information provided during the audit, the Division determined that petitioners did not provide adequate evidence to support substantial intercorporate transactions between KLC and Kindercare or KLC and its other affiliates and that petitioners' income and expenses were properly reflected on a separate basis.

15. The Division also made other adjustments to petitioners' tax filings for the audit years that were unrelated to combination. The first addressed petitioners' reported MCTD allocation percentage, a factor in the computation of the MTA surcharge. KLC's separately

[2] For the periods at issue, petitioners' New York franchise tax returns report business allocation percentages between one and two percent.

reported MCTD allocation percentage decreased from 32.3150% for 2005 to 0.0324% for 2006. On audit, the Division questioned this fluctuation and, in response, petitioners advised that KLC's MCTD allocation percentages for those years should have been 0.0803% and 13.9689%, respectively. Petitioners provided workpapers detailing the computation of these revised figures. At the hearing, petitioners explained that the volatility in the allocation percentage resulted from the KLC's involvement with a specific business activity ("No Child Left Behind" consulting) that was different from its normal day care center business. With respect to the 2005 tax year, such workpapers indicate that KLC had zero receipts and zero wages within the MCTD. A letter, dated August 31, 2009, accompanying the workpapers, asserts that none of KLC's centers had activity in the surcharge district in 2005. Kindercare separately reported MCTD allocation percentages of 53.5829% and 56.5928% for the 2005 and 2006 tax years, respectively. The Division articulated no challenge to these reported percentages either on audit or at the hearing. For the 2007 tax year, KLC and Kindercare reported an MCTD allocation percentage of 11.2563% on their combined return.

The Division adjusted petitioners' reported MCTD allocation percentages for all tax years at issue based on the ratio of the number of locations in the surcharge district to the total number of locations in the State during the years at issue. Petitioners provided such site information during the audit. Specifically, the site information indicated that KLC had 3 locations in the surcharge district and 11 total locations in New York State. Such site information further indicated that Kindercare had six locations in the surcharge district and nine in the State. The Division thus estimated MCTD allocation percentages for KLC and Kindercare to be 27.2727% and 66.6667%, respectively, for each of the three years at issue.

The second non-combination adjustment addressed the disallowance of a net operating loss (NOL) for Kindercare. An Internal Revenue Service revenue agent's report, dated November 24, 2006, and arising from a federal audit of Kindercare for earlier tax years, indicates that Kindercare was entitled to a loss of $22,434,663.00 on federal form 1139 arising during Kindercare's short tax year for the period June 2004 through January 2005.[3] As relevant herein, the purpose of form 1139 (Corporate Application for Tentative Refund) is to apply for a refund from the carryback of an NOL. For federal purposes, Kindercare did subsequently carryback the approximate $22 million NOL, in full, to earlier years. For New York purposes, Kindercare carried back a net operating loss of $10,000.00 from its tax year ended January 2005 to its tax year ended May 30, 2003 by filing with the Division forms CT-3360 (Federal Changes to Corporate Taxable Income) and amended corporate franchise tax returns for its tax years ended May 30, 2003 and May 28, 2004. Kindercare's New York return for its short tax year ended January 2005 is not in evidence. Kindercare did not claim a New York net operating loss on its separately filed franchise tax returns for its tax years ended December 31, 2005 or December 30, 2006. During the audit, petitioners provided the Division with the IRS revenue agent's report as well as Kindercare's reports of federal changes and amended returns as noted. The Division disallowed Kindercare's request, made during the audit, to carry forward the balance of the approximate $22 million federal NOL as a deduction for its tax year ended December 31, 2005. Kindercare has not filed any amended returns claiming any part of the $22 million federal NOL as a deduction.

[3] As noted, KLC acquired Kindercare in January 2005. Hence the short tax year.

16. As a result of the audit, the Division issued Notice of Deficiency #L-034441018, dated August 5, 2010, to Knowledge Learning Corporation, and Notice of Deficiency #L-034441579, dated August 5, 2010, to Kindercare Learning Centers, Inc., for the periods ending December 31, 2005, December 30, 2006 and December 29, 2007. Petitioners each filed a petition contesting the notices.

17. At the hearing, petitioners presented the testimony of Wendy Hamel, Lynette Alexander and David Benedict. Ms. Hamel was employed by Knowledge Universe, LLC (formerly known as KLC) as the income tax manager at the time of the hearing. She had been in that position for about four years. Ms. Hamel's duties include reviewing tax returns, preparing the accounting for income taxes and being the primary contact for the auditors.

18. In addition to Kindercare and Mulberry, KLC's affiliated group consisted of KC Distance Learning, Inc., Children's Creative Learning Centers, Inc., Science Enrichment Services, Inc., MSK Holding Corp., and KLC Realty, Inc.

At all times relevant herein, Mulberry was a wholly-owned subsidiary of Kindercare.

According to Ms. Hamel and petitioners' response to IDR 1, all employees of Kindercare, Mulberry and KC Distance Learning, Inc. became employees of KLC as of January 1, 2006.

According to Ms. Hamel and petitioners' response to IDR 1, KLC acquired Science Enrichment Services, Inc. in 2006 and the employees of that entity became KLC employees in September 2006.

Children's Creative Learning, Inc. was acquired by KLC in 2007. According to petitioners' response to IDR 1, employees of Children's Creative Learning, Inc. became employees of KLC in 2009.

Ms. Hamel, who was hired by KLC in July 2006, further testified that KLC hired, fired and supervised the employees.

19. Ms. Hamel testified that a memo was distributed to employees explaining that the employees were or would be employees of KLC as of January 1, 2006. Ms. Hamel also testified that the duties, obligations and daily activities of the employees did not change as a result of the transfer. Ms. Hamel was not aware of any employment contracts before the transfer of the employees and she testified that no written contracts were in existence to memorialize the transfer of the employees to KLC.

20. Kindercare reported $5,079,690.00 in New York wages and $386,416,398.00 in everywhere wages (for a payroll factor of 1.3146%) on its separately filed franchise tax return for the tax period ended December 30, 2006.

21. KLC did not report income from leasing employees to Kindercare on its separately filed 2006 New York franchise tax return. There were no agreements memorializing any intercompany services between the affiliates, except for a master intercompany lease, which is not in the record.

22. Lynette Alexander was employed by Knowledge Universe at the time of the hearing as the divisional director of operations. Before that, Ms. Alexander had been the regional director of operations for KLC since November 2005. Ms. Alexander's duties include supporting center operations and training center directors and district managers. Ms. Alexander was not employed by any of the affiliates at the time KLC purchased Kindercare.

23. Ms. Alexander testified that in 2006, Kindercare and Mulberry employees, among others, were all employed by KLC. Employees were notified of this change by a memo. She

further testified that her paycheck was issued by KLC, as well as her W-2 Form. Ms. Alexander stated that KLC handled all workers' compensation issues.

24. According to Ms. Alexander, in 2007, KLC employees were responsible for preparing the curriculum used by Kindercare and Mulberry, implementing risk management policies for all companies, handling transportation issues, dealing with regulatory authorities, collecting tuition, handling communications and handling warehousing and procurement functions. She further testified that center directors, who are KLC employees, do the hiring and firing at the various centers.

25. Ms. Alexander testified that the primary business of KLC, Kindercare and Mulberry was the provision of child learning services.

26. David Benedict was employed by Knowledge Universe Education at the time of the hearing as vice president tax and risk. Mr. Benedict was hired by Kindercare in January 1998 and transferred to KLC when KLC acquired Kindercare in January of 2005. Mr. Benedict's duties include providing oversight to the risk management function and running the tax function. Mr. Benedict performed the same duties at KLC as he had while working for Kindercare.

27. Mr. Benedict testified that KLC acquired Aramark Educational Resources in 2003. KLC acquired Ed Solutions, an entity engaged in the business of "No Child Left Behind" consulting, in 2004. According to Mr. Benedict and petitioners' response to IDR 1, KLC acquired Education Station, LLC, another entity engaged in "No Child Left Behind" consulting, in 2006. As noted previously, KLC acquired Science Enrichment Services, Inc. in 2006. According to Mr. Benedict, this company ran a summer day camp service.

28. Mr. Benedict stated that the legacy companies' employees became KLC employees and that there was no legal evidence, in the form of a documented agreement, of this transfer of employees to KLC. Mr. Benedict testified that, in 2007, almost all of the legacy learning centers were converted to Kindercare learning centers as a result of a rebranding study, dated December 13, 2005 (***see infra*** Finding of Fact 32).

29. It was through Mr. Benedict's testimony that a memo, dated November 14, 2005, was submitted into evidence. Petitioners rely upon this memo as showing the transfer of employees to KLC. Mr. Benedict testified that KLC adopted a common policy manual, a common code of ethics, a common employee handbook and a common employee benefits handbook.

30. Mr. Benedict testified that petitioners received a benefit in New York by filing on a combined basis in 2007.

31. As noted herein, the corporate acquisitions by KLC were part of a strategy to grow its child care and early childhood education business. With the acquisition of Kindercare in 2005, KLC management made the additional strategic decision to operate its subsidiaries, to the extent feasible, as a single business. Petitioners cited regulatory and legal complications as precluding the merger of the various corporations into a single corporate entity.

32. In 2005, KLC hired a consultant for advice as to whether KLC and its then-recently acquired subsidiaries should continue to operate under the different brand names used by its various affiliates. The consultant's report, dated December 13, 2005, recommended that KLC establish Kindercare as its single brand name.

33. Also in 2005, KLC engaged a tax consulting service to estimate the 2006 state unemployment tax rates and costs associated with a proposed January 1, 2006 "consolidation of

accounts and transfers of Kindercare experience into KLC's accounts." In describing the scope of the project in a July 21, 2005 letter, the consultant noted that Kindercare "is contemplated to be consolidated in whole into [KLC]" on or about January 1, 2006. The letter further noted that "it is possible that various states may not recognize this as a predecessor-successor business transfer and may require that separate accounts be maintained for the 'true' employers." The consultant estimated that the proposed consolidation would result in additional state unemployment insurance costs to KLC of about $897,000.00.

34. The November 14, 2005 memo, referred to in the testimony of petitioners' three witnesses, announced a new program of employee benefit plans for 2006. It is captioned, at the top, "One Company, Growing Together." The memo speaks of "bringing companies together" and addresses "the Knowledge Learning Corporation (KLC) team." It refers to "our success as a company" and notes the objectives of "creating a common benefit platform for all KLC companies" and "leveraging our size so we can take full advantage of what the market offers to large employers." It makes no express reference to any transfer of employees to KLC.

35. KLC's 2005 employer's annual federal unemployment tax return (form 940) reported $124,700,875.86 in total payments to all employees. Its 2006 form 940 reported $716,971,797.07 in total payments to all employees.

36. KLC's employer's quarterly federal tax return (form 941) for the 4th quarter of 2005 reported 14,285 employees as receiving wages for that period. KLC's form 941 for the 1st quarter of 2006 reported 42,614 employees receiving wages for that period.

37. As noted previously, petitioners provided spreadsheets as part of their response to IDR 1 in an effort to detail transactions between KLC and its affiliates (***see*** Finding of Fact 10).

The expense categories attributable to the cost of services for employees on the spreadsheets for the 2007 tax year are compensation, employee benefits, payroll taxes and employment costs. For Kindercare and Mulberry, these four categories total $468,641,391.00 and $37,884,338.00, respectively.

38. Following KLC's acquisition of Kindercare and Mulberry, janitorial services were provided to these subsidiaries pursuant to contracts entered into by KLC. KLC also contracted with third parties to provide transportation to its own centers, as well as Kindercare and Mulberry legacy centers. KLC also entered into arrangements nationally to purchase food and supplies on behalf of its Kindercare and Mulberry legacy centers.

39. Total costs attributable to janitorial service, transportation (fleet expense), food and supplies for the 2007 tax year for Kindercare and Mulberry were $70,898,297.00 and $4,378,801.00, respectively.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge first reviewed the standards for combined reporting pursuant to Tax Law § 211 (4), as amended for tax years commencing January 1, 2007. Pursuant to that provision, where there are substantial intercorporate transactions among the related corporations, a combined report is required. The Administrative Law Judge concluded, however, that petitioners failed to establish that such substantial intercorporate transactions existed during the 2007 tax year. Specifically, the Administrative Law Judge found that evidence presented was insufficient to show that the employees of the subsidiary corporations were transferred to KLC, as petitioners claim. The Administrative Law Judge also found that the employee transfers as described lacked a valid business purpose and economic substance because the duties, obligations and daily activities of the employees did not change as a result of the purported transfer.

The Administrative Law Judge dismissed petitioners' alternative argument that combined filing herein is necessary to avoid distortion by concluding that, under Tax Law § 211 (4), as amended, distortion is no longer the proper analysis in determining whether combined filing should be permitted or required.

With respect to the Division's audit adjustment of the MCTD allocation percentage in the computation of the MTA surcharge, the Administrative Law Judge found that petitioners did not substantiate the values it sought to use to determine the allocation percentage and therefore sustained the estimate used by the Division.

Finally, the Administrative Law Judge determined that petitioner Kindercare failed to prove entitlement to a net operating loss.

Accordingly, the Administrative Law Judge denied the petitions and sustained the notices of deficiency.

ARGUMENTS ON EXCEPTION

Petitioners assert that there were substantial intercorporate transactions between KLC and Kindercare and KLC and the other affiliates during the 2007 tax year and that, therefore, combined reporting is required pursuant to Tax Law § 211 (4). Specifically, petitioners contend that the substantial intercorporate transactions requirement was met on the expense side as more than 50% of Kindercare's main trade or business gross expenses were derived from intercompany transactions. On the receipts side, petitioners contend that the substantial intercorporate transactions test was met because 100% of Kindercare's receipts resulted from services provided by KLC employees. Petitioners contend that they proved that the employees of Kindercare and the other affiliates were transferred to KLC as of January 1, 2005, and that such transfer had a valid business purpose and economic substance. Accordingly, petitioners assert that payments to KLC for such employees were intercorporate transactions.

Petitioners also take issue with the Administrative Law Judge's interpretation of Tax Law § 211 (4), as revised, to the effect that distortion is not a factor in determining whether combined reporting should be permitted or required. Petitioners argue that the statute, the regulations promulgated thereunder, and the guidance published by the Division, indicate that distortion remains a factor in determining whether combined filing is appropriate, even in the absence of substantial intercorporate transactions.

On this point, petitioners assert that they have shown that, under the instant circumstances, separate filings by petitioners would distort their incomes, noting that all intercorporate charges between KLC and its affiliates were at cost.

Turning to the non-combination issues, petitioners contend that the Administrative Law Judge improperly sustained the Division's audit adjustment of the property factor component of the MCTD allocation percentage in the computation of the MTA surcharge. Petitioners assert that actual asset values were provided during the audit and should have been utilized by the Division.

Finally, petitioners contend that the Administrative Law Judge improperly determined that Kindercare was not entitled to a net operating loss deduction. Petitioners assert that sufficient proof of Kindercare's net operating loss of $22,434,663.00 was presented at the hearing and that Kindercare is entitled to claim such loss pursuant to Tax Law § 208 (9) (f) (5).

The Division contends that petitioners failed to substantiate their claim that Kindercare's employees were actually transferred to KLC. The Division further contends that, even if such employees were transferred, such transfer lacked economic substance and Kindercare's "hire-back" of the employees should not be considered intercorporate transactions for the purpose of determining whether substantial intercorporate transactions exist.

The Division also agrees with the Administrative Law Judge's conclusion that KLC's payment of Kindercare's expenses did not constitute intercorporate transactions because, given the cash management system utilized by KLC and its affiliates, such payment of expenses amounted to KLC paying Kindercare's expenses with Kindercare's cash.

The Division further asserts that petitioners have not shown that separate filing would result in distortion. The Division reasoned that, because petitioners have not shown that KLC provides any goods or services to Kindercare, there are no intercorporate transactions that require arm's length pricing. The Division thus contends that petitioners' activities are properly reflected on separate New York returns.

With respect to the MCTD allocation issue, the Division contends that no changes are warranted because the information regarding asset values conflicted with other information provided on audit. Accordingly, the Division asserts that the Administrative Law Judge properly sustained the Division's audit adjustment to petitioners' respective MCTD allocation percentages.

With respect to the net operating loss issue, the Division asserts that Kindercare has not proven the amount of its New York net operating loss for the short period return for the period ending January 2005 and, in turn, any net operating loss available for carry forward. The

Division thus contends that the Administrative Law Judge properly denied the claimed net operating loss.

OPINION

Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law § 209 [1]). While, as a general principle, every corporation is considered a separate taxpayer and must file its own report, under certain circumstances combined reporting may be permitted or required (20 NYCRR 6-2.1).

For taxable years commencing prior to January 1, 2007, Tax Law former § 211 (4) and the regulations promulgated thereunder gave the Division the discretion to permit or require combined filing where substantial ownership, unitary business and distortion tests were met (20 NYCRR former 6-2.1 [a]). Under this former regime, distortion was presumed where "substantial intercorporate transactions" were present (20 NYCRR former 6-2.3 [a]). Such a presumption could be rebutted by a showing that the transactions giving rise to the presumption were conducted at arm's length (***see Matter of Silver King Broadcasting of N.J.***, Tax Appeals Tribunal, May 9, 1996). In the absence of substantial intercorporate transactions, combined filing was permitted or required where "the filing of a report on a separate basis . . . results in a distortion of such taxpayer's activities, business, income or capital . . ." (20 NYCRR former 6-2.3 [d]).

Effective for taxable years commencing on or after January 1, 2007, Tax Law § 211 (4) (a) was amended (***see*** L 2007, ch 60) to require combined reporting where the substantial ownership requirement is met,[4] and where "there are substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions."[5]

To determine whether substantial intercorporate transactions exist, the statute further provides as follows:

> "the commissioner shall consider and evaluate all activities and transactions of the taxpayer and its related corporations. Activities and transactions that will be considered include, but are not limited to:
>
> (i) manufacturing, acquiring goods or property, or performing services, for related corporations; (ii) selling goods acquired from related corporations; (iii) financing sales of related corporations; (iv) performing related customer services using common facilities and employees for related corporations; (v) incurring expenses that benefit, directly or indirectly, one or more related corporations, and (vi) transferring assets, including such assets as accounts receivable, patents or trademarks from one or more related corporations" (Tax Law § 211 [4] [a]).

Consistent with the prior law and regulations, the Division's interim interpretation of Tax Law § 211 (4) as amended, a Technical Services Memorandum dated March 3, 2008 (TSB-M-08 [2] C), defines "substantial" as, generally, more than 50% and provides the following guidance regarding substantial intercorporate expenditures:

> "The substantial intercorporate transactions requirement will be met when, during the taxable year, 50% or more of a corporations expenditures included in the computation of entire net income, including for inventory (but excluding nonrecurring items), are from one or more related corporations. However, if a corporation's expenditures, including for inventory (but excluding recurring items), from one or more related corporations are between 45% and 55%, [a] multi-year test . . . applies.
>
> Expenditures incurred by a corporation that directly or indirectly benefit a

[4] The substantial ownership requirement was not in dispute and, indeed, the record shows that this requirement has been met (***see*** 20 NYCRR 6-2.2).

[5] As noted, petitioners used a 52-53 week accounting period. With respect to the 2007 taxable year, such accounting period began on December 31, 2006. Under the Division's regulations, petitioners' taxable year is deemed to have begun on January 1, 2007 (20 NYCRR 2-1.4 [b]). Accordingly, Tax Law § 211 (4), as amended (L 2007, ch 60), is applicable to petitioners' taxable years ended December 29, 2007.

> related corporation can constitute substantial intercorporate transactions. For example, when a related corporation is incurring expenditures that benefit another related corporation and the amount of those expenditures represent 50% or more of the expenditures of the first corporation or are equal to 50% or more of the direct and indirect expenditures of the beneficiary corporation, the substantial intercorporate transactions requirement is satisfied."

The Division's regulations promulgated under the amended statute, although not effective until 2013, provide for a similar test (***see*** 20 NYCRR 6-2.3 [b] [3]).

The Technical Services memorandum, like the Division's former and current regulations (see 20 NYCRR former 6-2.3 [c] and 20 NYCRR 6-2.3 [b] [2]) also provides that service functions like accounting, legal and personnel services are not to be considered when determining whether substantial intercorporate transactions exist when such services are incidental to the business of the corporation providing such service.

As amended, Tax Law § 211 (4) also provides for the filing of combined reports in the absence of substantial intercorporate transactions:

> "Except as provided in the first undesignated paragraph of this paragraph [i.e., except where there are substantial intercorporate transactions], no combined report covering any corporation 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 [Tax Law § 211 (5)], in order to properly reflect the tax liability under [Article 9-A]*" (Tax Law § 211 [4] [a] [4] [emphasis added]).

The italicized portion of the quoted paragraph is identical to language contained in Tax Law former § 211 (4) (a) (4). We have consistently interpreted this language to mean that, assuming all other requirements are met, combined filing is required to avoid distortion and to properly reflect income (***see***, ***e.g.***, ***Matter of Kellwood Co.***, Tax Appeals Tribunal, September 22, 2011). This interpretation is consistent with the Division's former regulations (***see*** 20 NYCRR former 6-2.3).

The March 3, 2008 Technical Services Memoradum interprets the amended statute in a similar manner. Specifically, the Memorandum notes that the Division "may require or permit" combined filing "even where substantial intercorporate transactions are absent" pursuant to the italicized statutory language quoted above in order to properly reflect income (***see*** TSB-M-08[2] C). Additionally, although not effective until 2013, the Division's regulations, interpreting the same statute, provide that a combined report "may be required or permitted" in the absence of substantial intercorporate transactions where ownership and unitary business conditions are met, and where a combined report is necessary to properly reflect income (***see*** 20 NYCRR 6-2.1 [b], 6-2.3 [d]).

Given the foregoing, we find that the Administrative Law Judge erroneously concluded that, following the 2007 amendments to Tax Law § 211 (4), distortion is no longer a factor for determining combined filing. We reverse on this point, and conclude that Tax Law § 211 (4), as amended, allows combined reports to be filed, even in the absence of substantial intercorporate transactions, when combined filing is necessary to properly reflect income and avoid distortion.

In the present matter, the dispute over combined filing focused on whether there were substantial intercorporate expenditures during the 2007 tax year between KLC and Kindercare and KLC and Mulberry. Petitioners assert that KLC's provision of employees to Kindercare and Mulberry and those subsidiaries' reimbursement of KLC at cost for those employees comprised the bulk of such transactions. As noted previously, the Administrative Law Judge determined that petitioners failed to establish that the employees were transferred to KLC, as claimed. More specifically, the Administrative Law Judge concluded that the November 14, 2005 memorandum, described by each of petitioners' witnesses as KLC's notice of the impending transfer to rank and file employees, did not show any such transfer. The Administrative Law Judge then dismissed the testimony of petitioners' witnesses because it provided no detail on the purported transfer except to rely on the November 14, 2005 memo.

We disagree with the Administrative Law Judge on this point. Considering the entirety of the record, we find that petitioners have met their burden to show that the employees of Kindercare and Mulberry were transferred to KLC as of January 1, 2006, as claimed.

The July 21, 2005 letter to KLC from the tax consulting service provides objective, contemporaneous evidence of KLC's intent to transfer all employees of Kindercare and Mulberry to its payroll as of January 1, 2006. The consultant's cautionary advice that the transfer might not be recognized in some states does not, in our view, diminish KLC's intent, as stated in the letter, to shift Kindercare and Mulberry employees to KLC's payroll.

That such a shift occurred is strongly supported by KLC's federal unemployment tax returns for 2005 and 2006. These returns establish an increase in both payroll and number of employees for KLC in 2006 and thus indicate that Kindercare and Mulberry employees were transferred to KLC, as claimed. We note that the approximate $717 million in total payments to employees as reported on KLC's 2006 form 940 (***see*** Finding of Fact 35) is consistent with the approximate $703 million aggregate total of wages as reported by KLC and Kindercare on their 2006 New York franchise tax returns and the wages paid by Mulberry as indicated in IDR 1. Specifically, KLC reported about $285 million and Kindercare reported about $386 million in wages on their respective 2006 New York returns, and the IDR 1 indicates that Mulberry paid about $32 million in wages for that year. As to the probative value of a form 941 in this context, we note that the Division's witness at the hearing testified that the Division typically reviews 941's to verify payroll factors in franchise tax audits.

The balance of the documentation offered to prove the transfer of employees demonstrates KLC's business strategy of operating as a single company. Specifically, the December 15, 2005 consultant's report recommending that KLC use Kindercare as its single brand going forward plainly shows the single company strategy. Additionally, the November 14, 2005 memorandum, although touted by petitioners' witnesses as announcing the employee transfer, contains no language expressly indicating such a transfer, but does promise "a common benefit platform for all KLC companies" beginning in 2006. Such a common benefit platform is consistent with the strategy of operating as a single company. The 2007 benefits handbook shows that a common set of benefits was created by KLC, as it provides that it supercedes any such handbook previously distributed by KLC's subsidiaries, including Kindercare and Mulberry. Similarly, the March 2006 policy manual is indicative of an intent to operate as a single company with a single set of policies. Like the benefits handbook, the policy manual also provides that it supercedes any such handbook previously distributed by KLC or its subsidiaries, including Kindercare and Mulberry. The code of ethics and employee handbook are also indicative of the single company strategy.

Certainly, as the Division notes in its brief, KLC and its subsidiaries could have pursued its single company strategy without transferring employees to KLC. The transfer of employees, however, is clearly consistent with this strategy and, indeed, may be viewed as one means of implementing the strategy. To that extent, then, the evidence demonstrating the single company strategy corroborates the direct documentary evidence (i.e., the tax consultant's letter and the federal unemployment tax returns) of the transfer of Kindercare and Mulberry employees to KLC.

Finally, we note that the Administrative Law Judge did not make a finding that the testimony of petitioners' witnesses' lacked credibility. We are therefore not inclined to defer to the Administrative Law Judge's dismissal of such testimony (***cf.***, ***Matter of MediaBuss Sys., Inc.***, Tax Appeals Tribunal, March 18, 2014 [DTA No. 824207]). Upon our review of the transcript herein, and in light of all of the documents discussed above, we find that the testimony of petitioners' witnesses credibly supports petitioners' claim that Kindercare and Mulberry employees were transferred to KLC as of January 1, 2006.

In its brief, the Division notes that petitioners' separately filed 2006 New York franchise tax returns do not support a finding that employees were transferred to KLC, as claimed (***see*** Findings of Fact 20 and 21). While we agree with the Division on this point, we conclude that such evidence is outweighed by the other evidence in the record, discussed above, supporting a finding in favor of the employee transfer.

As noted, the determination below also concluded that, even if the transfer of employees occurred as claimed, such transfer lacked a valid business purpose and economic substance and that, therefore, such transactions should not be considered for the purpose of determining whether substantial intercorporate transactions exist.

We disagree and find that the transfer of employees was part of KLC's reasonable business strategy of operating its subsidiaries as a single company. In addition to the consolidation of its employees onto one payroll, the record shows that this strategy had other components, including centralized cash management, centralized risk management, centralized purchasing, and a common curriculum (***see*** Findings of Fact 11 and 24). We further note that the record does not support a finding that the employee transfer was tax-motivated because the modest benefits derived by petitioners from combined filing were more than offset by the increase in unemployment insurance taxes attributable to the transfer (***see*** Findings of Fact 30 and 33). We conclude, therefore, that the employee transfers had a valid business purpose.

The determination and the Division's brief on exception find a lack of economic substance in the transfer of employees by the fact that the duties, obligations and daily activities of the employees did not change following their transfer to KLC. We agree with petitioners that this is not the proper analysis to determine whether the transfer of employees had economic substance. Rather, in the present context, we find that the issue of economic substance depends upon whether a common law employer-employee relationship existed between KLC and the former Kindercare and Mulberry employees following the transfer. The indicia of such a relationship are well-established and include the authority to hire and fire, authority to control and direct the work of the employee, and the payment of wages (***see e.g.***, ***Albany College of Pharm. v Ross***, 94 Misc 2d 389 [1978]; ***Matter of O'Keh Caterers Corp.***, Tax Appeals Tribunal, June 3, 1993; Treas. Reg. § 31.3401 [c]-1).

The record shows that a common law employer-employee relationship existed between KLC and the former Kindercare and Mulberry employees following the transfer. Specifically, the testimony presented shows that KLC employees hired, fired and supervised workers (***see*** Finding of Fact 24) and that, as discussed previously, all employees were paid by KLC. Accordingly, we find that the transfer of employees from the subsidiaries to KLC had economic substance.

This matter is distinguishable from ***Matter of Sherwin-Williams Co.***, Tax Appeals Tribunal, June 5, 2003 ***affd Sherwin-Williams Co. v Tax Appeals Trib. of Dept. of Taxation & Fin. of State of N.Y.***, 12 AD3d 112 (2004), ***lv denied***, 4 NY3d 709 (2005), cited in both the determination and the Division's brief. That case involved a parent's assignment and license-back of trademarks to a subsidiary. In our decision, we noted that "it is apparent to us that the functions of Sherwin-Williams have not changed after the transactions creating the assignment and license-back of the Marks. Therefore, the only obvious benefit that we can see here is that Sherwin-Williams was successfully able to avoid taxes." We made this statement in the context of a finding that the transactions in that case were tax-motivated and lacked both a valid business purpose and economic substance. Here, the opposite is true. The transfer of employees was not tax-motivated, it was part of a reasonable business strategy and it had economic substance. Moreover, the the analogous parties in the present matter to the parent and subsidiary in ***Sherwin-Williams*** are not the former Kindercare and Mulberry employees, but are the corporate entities, KLC, Kindercare and Mulberry. Clearly, the functions of these entities did change; KLC took on the duties and responsibilities of an employer for the former Kindercare and Mulberry employees and the subsidiaries no longer had any such responsibilities.

Having concluded that the former employees of Kindercare and Mulberry were transferred to KLC as of January 1, 2006, and that such transfer had a valid business purpose and economic substance, we find that payments by those subsidiaries to KLC attributable to the cost of the services of those employees constituted intercorporate transactions for purposes of Tax Law § 211 (4) (a).

We also conclude that payments made by Kindercare and Mulberry to KLC for janitorial services, transportation services, food and supplies were intercorporate transactions for purposes of Tax Law § 211 (4) (a). We note that, with respect to each of these categories, KLC made the purchases from third party providers and then allocated the costs to the appropriate center. We thus disagree with the Division's characterization of these transactions as KLC paying Kindercare's expenses with Kindercare's cash.

The record herein thus indicates that Kindercare's intercorporate expenditures with KLC during the 2007 tax year totaled $539,539,688.00 out of $948,388,947.00 in overall expenses for that year (***see*** Findings of Fact 10, 37, and 39). This amounts to 56.89% of Kindercare's total expenditures. Mulberry's intercorporate expenditures with KLC during the 2007 tax year totaled $42,263,139.00 out of $67,524,622.00 in overall expenditures for that year (***see*** Findings of Fact 10, 37, and 39). This amounts to 62.59% of its total. Accordingly, Kindercare and KLC, and Mulberry and KLC, have met the substantial intercorporate transactions test for combined filing for the 2007 tax year.

Having concluded that KLC, Kindercare and Mulberry have met the substantial intercorporate transactions test for combination, it is not necessary to determine whether combined filing for these entities is required pursuant to distortion standards.

We note that petitioners did not present sufficient evidence to prove that any of the remaining members of the proposed combined group had substantial intercorporate transactions with KLC. Moreover, petitioners made no argument to support a finding that the combination of such other affiliates with KLC is necessary to avoid distortion.

We turn next to the Division's adjustment of petitioners' reported MCTD allocation percentages.[6] A taxpayer's MCTD surcharge is computed by multiplying the taxpayer's net New York State franchise tax by the taxpayer's MCTD allocation percentage and then applying the surcharge rate (***see*** Tax Law § 209-B [1]). The MCTD allocation percentage is determined by calculating the average of a property factor, a receipts factor and a payroll factor (***see*** Tax Law § 209-B [2]). These factors themselves are percentages, representing the ratio of the value of the taxpayer's property within the district to the value of the taxpayer's property within the state (***see*** Tax Law § 209-B [2] [a]); receipts in the regular course of business within the district to such receipts within the state (***see*** Tax Law § 209-B [2] [b]); and payroll within the district to payroll within the state (***see*** Tax Law § 209-B [2] [c]).

KLC has failed to prove that the MCTD allocation estimate used by the Division with respect to the 2005 tax year was in error. The basis for this estimate was the fluctuation in KLC's reported allocation percentage from about 32% in 2005 to about .03% in 2006. KLC conceded that its MCTD allocation percentage as reported was erroneous and offered a revised allocation percentage on audit. KLC's revised allocation percentage of about .08% for 2005 is premised on a claim of zero activity in the surcharge district during the 2005 tax year. The accuracy of this claim, however, is undermined by other evidence in the record indicating that KLC operated three centers in the reporting district during 2005. Specifically, the Division reviewed the list of New York centers provided by petitioners during the audit and found that KLC operated three centers in the surcharge district in 2005. At the hearing, petitioners took issue with the Division's audit estimate of KLC's MCTD allocation percentage based on the

[6] Both parties incorrectly argued that the issue here was whether the Division properly adjusted the property component of the MCTD allocation percentage (***see*** Tax Law § 209-B [2] [a]). The audit workpapers clearly show that the Division adjusted the MCTD allocation percentage.

number of centers in the district versus the total number of centers in the state, but did not take issue with the Division's assertion that KLC did, in fact, operate three centers in the surcharge district in 2005. We thus conclude that KLC has not shown that the Division's estimate was in error.

With respect to 2006, upon review of KLC's revised allocation percentage and supporting workpapers, and in the absence of any apparent errors in such calculations or any errors in such calculations claimed by the Division, we find that KLC's revised MCTD allocation percentage as provided during the audit was accurate.

Considering the absence of any significant fluctuation in Kindercare's reported MCTD allocation percentage for the 2005 and 2006 tax years, and the absence of any articulated reason for the disallowance of Kindercare's reported MCTD allocation percentage for the 2005 and 2006 tax years, and upon review of Kindercare's separately-filed returns for those years, we find that Kindercare has established that the Division's disallowance of its reported MCTD allocation percentage was improper.

With respect to the 2007 tax year, having determined that KLC and Kindercare must file on a combined basis, there is no rationale for the use of the separate estimated allocation percentages determined on audit.

Finally, we find that the Administrative Law Judge properly rejected Kindercare's claim for a net operating loss deduction for the 2005 tax year. As the Division correctly notes in its brief on exception, the regulations require that a net operating loss deduction be adjusted to reflect the additions to and subtractions from federal taxable income required under Article 9-A (***see*** 20 NYCRR 3-8.2 [c]). Kindercare has not established that it accounted for such additions and subtractions. It has, therefore, failed to prove the amount of any claimed NOL deduction for its 2005 tax year.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Knowledge Learning Corporation and Kindercare Learning Centers, Inc. is granted to the following extent:

a. The Division of Taxation is directed to permit these petitioners, along with their affiliate, Mulberry Child Care Centers, Inc., to file corporation franchise tax returns on a combined basis for the tax year ended December 29, 2007;

b. The Division of Taxation is directed to recompute petitioners' MCTD allocation percentages for the years at issue in accordance with this decision;

c. The exception is in all other respects denied;

2. The determination of the Administrative Law Judge is reversed to the extent indicated above, but it is otherwise affirmed as modified;

3. The petitions of Knowledge Learning Corporation and Kindercare Learning Centers, Inc. are granted to the extent indicated above, but are otherwise denied;

4. The notice of deficiency numbered L-034441018, dated August 5, 2010, and issued to petitioner Knowledge Learning Corporation is modified to the extent indicated above, but is otherwise sustained; and

5. The notice of deficiency numbered L-034441579, dated August 5, 2010, and issued to petitioner Kindercare Learning Centers, Inc. is modified to the extent indicated above, but is otherwise sustained.

DATED: Albany, New York
September 18, 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