STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

NORDSTROM, INC. AND COMBINED AFFILIATES : DETERMINATION DTA NO. 828931

:

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Period February 1, 2009 through January 28, 2012. :

Petitioner, Nordstrom, Inc., and Combined Affiliates, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under article 9-A of the Tax Law for the period February 1, 2009 through January 28, 2012.

A videoconferencing hearing via CISCO Webex was held before Barbara J. Russo, Administrative Law Judge, on April 5, 2021 at 10:30 a.m., with the final brief to be submitted by January 7, 2022, which date commenced the six-month period for issuance of this determination. Petitioner appeared by Mayer Brown LLP (Leah Robinson, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (James Passineau, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined that petitioner was not entitled to remove from its combined returns NIHC, Inc.'s income from the deferral of intercorporate profits for fiscal years ending January 31, 2010, January 31, 2011, and January 28, 2012.

II. Whether the Division of Taxation properly disallowed petitioner's claimed deductions for bad debt expenses.

III. Whether petitioner has shown reasonable cause for the abatement of penalties.

FINDINGS OF FACT[1]

1. Nordstrom, Inc. (Nordstrom), is a Washington State corporation and is the parent of the Nordstrom Group.

2. Nordstrom is a fashion specialty retailer that sells merchandise through brick-and-mortar store locations in New York and throughout the United States and through a website.

3. N2HC, Inc. (N2HC) is a Colorado corporation. It is a direct subsidiary of Nordstrom.

4. N2HC holds a right to license intangibles, such as the Nordstrom trade names.

5. NIHC, Inc. (NIHC)[2] is a Colorado corporation. It is a direct subsidiary of N2HC.

6. NIHC owns various intangibles, such as the Nordstrom trade names.

7. Nordstrom Distribution, Inc. (NDI) is a Washington corporation. It is a direct subsidiary of Nordstrom.

8. Nordstrom Distribution Management, Inc. (NDMI) is an Oregon Corporation. It is a direct subsidiary of Nordstrom.

9. Nordstrom fsb ("FSB") is a savings and loan bank that is federally chartered with its home office in Arizona. It is a direct subsidiary of Nordstrom.

10. Nordstrom Credit, Inc. (NCI) is a Colorado corporation. It is a direct subsidiary of Nordstrom.

[1] The parties entered into a joint stipulation of facts with attached exhibits that were jointly introduced into the record in this proceeding. The relevant stipulated facts have been incorporated herein.

[2] NIHC is sometimes referred to as "N1HC" in the Division of Taxation's (Division's) audit file (with the

11. There are additional entities in the overall group that are not named here.

12. Some documents in the record list the corporations by federal EIN rather by name, as follows:

a. Nordstrom, Inc.: XX-XXX5058

b. N2HC: XX-XXX0480

c. NIHC: XX-XXX1956.[3]

Tax Filing and Audit History

13. Each Nordstrom entity uses a fiscal year-end (FYE), rather than a calendar year-end for tax filing purposes.

14. For all years, Nordstrom filed federal income tax returns on a consolidated basis including all domestic subsidiary corporations relevant to this matter. Copies of the federal income tax returns filed on a consolidated basis for FYE 01/31/1999; FYE 01/31/2000; FYE 01/31/2009; FYE 01/30/2010; FYE 01/29/2011; and FYE 01/28/2012 were introduced into the record with the joint stipulation of facts and exhibits.

15. Nordstrom filed its New York State franchise tax returns as follows:

Fiscal Year Dates	FYE Title	Tax Year	Return Filed
02/01/1995 to 01/31/1996	FYE 01/31/1996	1995	Form CT-3 (separate entity return) including Nordstrom only
02/01/1996 to 01/31/1997	FYE 01/31/1997	1996	Form CT-3 (separate entity return) including Nordstrom only
02/01/1997 to 01/31/1998	FYE 01/31/1998	1997	Form CT-3 (separate entity return) including Nordstrom only
02/01/1998 to 01/31/1999	FYE 01/31/1999	1998	Form CT-3 (separate entity return) including Nordstrom only
02/01/1999 to	FYE 01/31/2000	1999	Form CT-3 (separate entity return)

numeral 1 instead of the letter I).

[3] The EINs have been partially redacted for privacy.

01/31/2000			including Nordstrom only
02/01/2000 to 01/31/2001	FYE 01/31/2001	2000	Form CT-3 (separate entity return) including Nordstrom only
02/01/2001 to 01/31/2002	FYE 01/31/2002	2001	Form CT-3 (separate entity return) including Nordstrom only
02/01/2002 to 1/31/2003	FYE 01/31/2003	2002	Form CT-3 (separate entity return) including Nordstrom only
02/01/203 to 01/31/2004	FYE 01/31/2004	2003	Original Form CT-3 (separate entity return) including Nordstrom only
02/01/203 to 01/31/2004	FYE 01/31/2004	2003	Amended Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
02/01/2004 to 01/29/2005	FYE 01/29/2005	2004	Original Form CT-3 (separate entity return) including Nordstrom only
02/01/2004 to 01/29/2005	FYE 01/29/2005	2004	Amended Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
01/30/2005 to 01/28/2006	FYE 01/28/2006	2005	Original Form CT-3 (separate entity return) including Nordstrom only
01/30/2005 to 01/28/2006	FYE 01/28/2006	2005	Amended Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
01/29/2006 to 02/03/2007	FYE 02/03/2007	2006	Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
02/04/2007 to 02/02/2008	FYE 02/02/2008	2007	Original Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
02/04/2007 to 02/02/2008	FYE 02/02/2008	2007	Amended Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
02/03/2008 to 01/31/2009	FYE 01/31/2009	2008	Original Form CT-3A (combined return) including Nordstrom, N2HC, NDI, and NDMI only
02/03/2008 to 01/31/2009	FYE 01/31/2009	2008	Amended Form CT-3A (combined return) including Nordstrom, N2HC, NDI, NDMI and NIHC only[4]
02/01/2009 to	FYE 01/30/2010	2009	Form CT-3A (combined return)

[4] In February 2013, subsequent to a closing agreement entered into by the parties in December 2010, which included FYE 01/31/2009 (discussed below), petitioner amended its returns for FYE 01/31/2009, reflecting the closing agreement settlement methodology, which resulted in inclusion of NIHC in the combined group, but inclusion of less than 100% of NIHC's income as reported to the Internal Revenue Service (20% reduction). The tax computations shown on the closing agreement workpaper tie to the separate entity figures on the amended return.

01/30/2010			including Nordstrom, N2HC, NDI, NDMI and NIHC only
01/31/2010 to 01/29/2011	FYE 01/29/2011	2010	Form CT-3A (combined return) including Nordstrom, N2HC, NDI, NDMI and NIHC only
01/30/2011 to 01/28/2012	FYE 01/28/2012	2011	Form CT-3A (combined return) including Nordstrom, N2HC, NDI, NDMI and NIHC only

Petitioner's original and amended returns, as described above, for FYE 01/31/2003 through FYE 01/28/2012 are included in the record as attachments to the joint stipulation.

16. Nordstrom's New York State tax returns for the fiscal years ending before 01/31/2003 are no longer available. However, the parties stipulated that the available returns for FYE 01/31/2003 and FYE 01/31/2004 are representative of the returns filed for FYE 01/31/1999 through FYE 01/31/2002.

17. Each of the tax years FYE 01/31/1999 through FYE 01/28/2012 was a part of one or more Division audits, as described below.

18. The Division of Taxation (Division) undertook an audit of petitioner's separate company returns for FYE 01/31/1996 through FYE 01/31/2003 (the First NY Audit).

19. Nordstrom and the Division entered into a closing agreement to resolve the First NY Audit. The settlement agreement retained the separate company filing status of Nordstrom and required Nordstrom to pay additional tax equal to 75% of the tax due after adding back royalty and interest payments to N2HC and another company, NTN, Inc. There is no mention of NIHC in the First NY Audit closing agreement documents. The closing agreement and related documents for the First NY Audit are included in the record as attachments to the joint stipulation.

20. The Division undertook an audit of petitioner's combined returns for FYE 01/31/2004 through FYE 01/28/2006, which also included a review of changes Nordstrom reported from its federal audit for FYE 01/31/2001, FYE 01/31/2002, and FYE 01/31/2003 (the Second NY Audit). The Division's auditor testified that as part of the Second NY audit, the Division reviewed petitioner's amended returns for FYE 01/31/04 through 1/28/06, which included N2HC but not NIHC. The Division disagreed with the inclusion of N2HC's amortized deduction without inclusion of the corresponding gain from NIHC. The Division stated in its audit report for the Second NY Audit that NIHC lacked economic substance, had no economic risk, no meaningful transactions with third parties and determined NIHC should be included in the Nordstrom group combined return to properly match NIHC's gain with N2HC's amortized expense (***see*** findings of fact 39 through 55).

21. The Division undertook an audit of petitioner's combined returns for FYE 02/03/2007 through FYE 01/31/2009 (the Third NY Audit).

22. Many discussions related to the Second NY Audit and the Third NY Audit occurred simultaneously. During the Second NY Audit and the Third NY Audit, the Division asserted that NIHC should have been included in the Nordstrom Group combined return. The Division's workpapers for each audit reflected inclusion of the income NIHC reported on the Nordstrom federal consolidated returns. Petitioner disagreed with inclusion of NIHC in the combined New York group.

23. Nordstrom and the Division entered into two closing agreements on or about the same date to resolve the Second NY Audit and the Third NY Audit.

24. The closing agreement for the Second NY Audit does not itself describe the basis for the settlement or the issues resolved. The closing agreement and attached workpapers confirm that the compromise reflected Nordstrom agreeing to pay 80% of the tax the Division computed to be due from inclusion of NIHC in the combined filing group. The Second NY Audit settlement amount was computed based on the amount NIHC actually reported as its federal taxable income. The closing agreement specifically states that the parties' compromise "has no impact on franchise tax liabilities or filing positions of other periods." The closing agreement and related documents are included in the record as an attachment to the joint stipulation.

25. The closing agreement for the Third NY audit specifies that the parties' compromise was "solely with respect to the issues of combined reporting with N2HC, Inc. and NIHC, Inc. for the Audit Period" and for a federal change in the FYE 2/3/2007. As part of the compromise, Nordstrom agreed to pay 80% of the tax the Division computed to be due from inclusion of NIHC in the combined filing group. The Third NY Audit settlement amount was computed based on the amount NIHC actually reported as its federal taxable income. The closing agreement further states that "no adjustment will be made to Nordstrom, Inc.'s bad debt deduction." The closing agreement provides that the parties' settlement has no impact on franchise tax liabilities or filing positions for other periods. The closing agreement and related documents are included in the record as an attachment to the joint stipulation.

26. The Division undertook an audit of petitioner's combined returns for FYE 02/01/2010 through 01/28/2012 (the years at issue). The audit for the years at issue is the subject of this matter.

27. The audits discussed above and audit resolution statuses are summarized as follows:

Fiscal Year Dates	Audit Cycle	Audit Resolution
02/01/1995 to 01/31/1996 02/01/1996 to 01/31/1997 02/01/1997 to 01/31/1998	Part of the First NY Audit	No additional tax
02/01/1998 to 01/31/1999 02/01/1999 to 01/31/2000 02/01/2000 to 01/31/2001 02/01/2001 to 01/31/2002 02/01/2002 to 01/31/2003	Part of the First NY Audit	Closing agreement (Tab 8-A to joint stipulation of facts)
02/01/2003 to 01/31/2004 02/01/2004 to 01/31/2005 02/01/2005 to 01/31/2006	Second NY Audit (federal changes for FYE2001-FYE2003 also included in Second NY Audit)	Closing agreement (Tab 8-B to joint stipulation of facts)
01/29/2006 to 02/03/2007 02/04/2007 to 02/02/2008 02/03/2008 to 01/31/2009	Third NY Audit	Closing agreement (Tab 8-C to joint stipulation of facts)
02/01/2009 to 01/30/2010 01/31/2010 to 01/29/2011 01/30/2011 to 01/28/2012	Fourth NY Audit	Closed disagreed (the matter at issue herein)

28. Contemporaneous with the Fourth NY Audit, the Division simultaneously performed an audit of FSB's returns filed on a separate entity basis under article 32 (franchise tax on banking institutions for the years ending 1/30/2010, 1/29/2011, and 1/28/2012). That audit was closed on a disagreed basis and a petition was filed with the Division of Tax Appeals and assigned DTA No. 828932. The parties subsequently entered into a Stipulation for Discontinuance and the matter was closed by Order of Discontinuance dated July 30, 2021. Such matter is not at issue herein.

29. During the Fourth NY Audit, the Division initially considered whether petitioner should include subsidiary NCI in the combined New York group. Petitioner did not agree with inclusion of NCI and informed the Division of its reasoning for continuing to exclude NCI from the combined group. Ultimately, the Division agreed that NCI would not be part of the

Nordstrom combined group, and its notice of deficiency and related workpapers do not reflect inclusion of NCI in the combined group. After schedules were sent that disallowed the bad debt expense, petitioner brought what it identified as an error in its returns as filed for each FYE 02/01/2010 through 01/28/2012 to the Division's attention. The asserted error is a claimed overstatement of NIHC's income (the § 311 [b] Issue) (26 USC 311 [b], hereinafter referred to as § 311 [b]) in each of the Fourth NY Audit years, discussed further below.

30. At the conclusion of the Fourth NY Audit, the Division proposed various audit changes, which included a penalty for the substantial understatement of tax pursuant to Tax Law § 1085 (k) (1).

31. By letter to the Division dated May 17, 2018, petitioner discussed what it perceived to be an error in the computations. Petitioner asserted that NIHC's income was overstated in each audit year. This issue is referred to in the audit file as the "§ 311 (b) Issue." Petitioner had previously raised the § 311 (b) Issue to the Division by letter dated December 18, 2017, providing its reasoning for correction of the alleged error. The letter was received by the Division on or about December 19, 2017. The Division's audit activity log specifically references the § 311 (b) Issue in its February 15, 2018 entry. Additionally, internal Division email correspondence dated March 14, 2018, contained in the audit file reflects the auditor and other Division personnel discussing the § 311 (b) Issue at that time.

32. The Division informed petitioner that it would not be allowed to correct NIHC's computation of entire net income. As stated, in part, in the Division's Audit Report, the Division determined that petitioner's request to remove the § 311 (b) gain during the audit period was inappropriate, untimely and distortionary, since the majority of the gain had already been

consistently reported under closing agreements executed with the Division (FYE 1/1999 through FYE 1/2009) and the majority of the 15 years were already closed under statute. The audit report further states that "Tax Law section 208(d) and Regulation Section 3-2.8 permit use of the same method of accounting used for Federal income tax purposes."

33. Petitioner submitted a written request for the abatement of penalties, asserting that reasonable cause existed for its filing position, which followed the statutory regime, and which is a pre-requisite for a discretionary adjustment.

34. The Division responded to the abatement request in writing, denying the application for penalty abatement, stating that the adjustment "is a change to Federal taxable income which is an above the line adjustment and not a discretionary adjustment."

35. The Division issued a notice of deficiency, L-048545749, dated July 12, 2018 (notice), that is the subject of this matter.

36. The notice asserted additional tax of $1,468,716.00 plus interest and substantial understatement penalties. The adjustments contained in the notice include disallowance of the bad debt deduction taken by petitioner in its computation of federal taxable income. The notice also continues to include NIHC's income related to the § 311 (b) Issue.

37. As part of the normal course of the Fourth NY Audit, the Division developed an audit file containing various documents that were received from petitioner, received from related entity FSB who had a contemporaneous audit, pulled from public sources, and developed by the Division. A copy of the audit file was presented into the record as an attachment to the joint stipulation of facts.

Background Historic Transactions

38. The Nordstrom companies underwent an internal restructuring of its intellectual property holdings (the Marks). Those restructurings consisted of the various transactions described in findings of fact 38 through 45.

39. In 1996, Nordstrom contributed the right to the Marks to newly formed NIHC in a transaction qualifying for nonrecognition under Internal Revenue Code (IRC) (26 USC) § 351.

40. Nordstrom's basis in the Marks was $0.00; as a result, NIHC's basis in the right to license the Marks was also $0.00.

41. In March 1997, Nordstrom incorporated N2HC, contributing cash to N2HC in exchange for 100% of the stock of N2HC in a transaction qualifying for nonrecognition under IRC (26 USC) § 351.

42. Also in March 1997, Nordstrom contributed ownership of the Marks to NTN, Inc. (NTN) in a separate transaction that also qualified for nonrecognition treatment. In April 1997, Nordstrom contributed the stock of NTN and NIHC to N2HC in exchange for cash.

43. On January 31, 1999, NIHC distributed the right to license the Marks for the tax years beginning after January 31, 1999 to N2HC. The fair market value of those rights was determined to be $2,792,000,010.00 (hereinafter referred to as $2.8B).

44. In February 1999, N2HC licensed the right to use the Marks to Nordstrom.

45. Later, NTN assigned the Marks to NIHC.

<u>§ 311 (b) Issue</u>

46. As stated in finding of fact 43, on January 31, 1999, NIHC distributed the right to license the Marks for the tax years beginning after January 31, 1999 to N2HC and the fair market value of those rights was determined to be $2.8B.

47. NIHC's distribution of property (the right to license the Marks) to N2HC was not a tax-free transaction for federal income tax purposes, but rather had significant tax consequences as described below.

48. The difference between the fair market value of the property and NIHC's adjusted basis in the property on the day of the distribution was $2.8B.

49. The $2.8B amount is also the amount N2HC took as the basis in the property it received from NIHC.

50. Pursuant to federal tax laws, N2HC was required to recover this basis through equal amortization deductions over 15 years. A pro rata portion (1/12th of 1/15th) was deducted in FYE 1/31/1999, with $186,133,334.00 taken as an amortization deduction each tax year for the following 15 years.

51. Pursuant to federal tax laws, N2HC was required to use the 15-year amortization schedule whether or not it was included in the same federal consolidated return as NIHC.

52. While N2HC's ability to deduct the amortization was not controlled by whether it and NIHC were included in the same federal consolidated return, the timing for NIHC to recognize the $2.8B of realized income was controlled by whether it and N2HC were included in the same federal consolidated return.

53. Larry Snider, the Division's Corporate Tax Auditor 2, testified on cross-examination that "on a theoretical basis," if NIHC had not been included in the same federal consolidated return as N2HC, it would have been required to recognize the full $2.8B in the year of the transaction. Similarly, petitioner's Vice President of Tax, Misty Heckel, testified that if NIHC had not been included in the same consolidated return with N2HC it would have been required to

recognize all of the gain in the year of transaction. Both Mr. Snider and Ms. Heckel also testified that for federal tax return purposes, if NIHC were included in the same federal consolidated return as N2HC, it would recognize the gain over a 15-year period, as was done on the returns here.

54. For federal return purposes, NIHC was included in the same federal consolidated filing group as N2HC at the time of the distribution. Therefore, the IRC provisions, U.S. Treasury Regulations and rules governing federal consolidated returns (together, the Federal Consolidated Return Rules) applied and federal deferral of NIHC's gain was required.

55. Because the Federal Consolidated Return Rules applied, for the 15 years starting with FYE 01/31/1999, on the federal consolidated returns filed by Nordstrom, which included both N2HC and NIHC, NIHC recognized income following the amortization schedule N2HC was required to use (i.e., 1/15th per year for 15 years). This resulted in NIHC including $186,133,334.00 in income each year. The amounts were pro-rated in the first and last of the 15 years, based on the date of the actual distribution in the first year.

56. On petitioner's combined returns for each of the years at issue, petitioner included $186,333,334.00 for NIHC's gain from the intercompany transaction with N2HC in its computation of combined entire net income (ENI), except that for the first year at issue (FYE 1/30/2010) petitioner reduced the NIHC income by 20%. The Division disallowed the reduction.

57. During the years at issue, 20 NYCRR § 3-2.2 (c), which defined entire net income for a separate entity return, stated, in part: "Each corporation included in a Federal consolidated group must compute its Federal taxable income for purposes of article 9-A of the Tax Law as if

such corporation had computed its Federal taxable income on a separate basis for Federal income tax purposes."

58. During the years at issue, 20 NYCRR § 3-2.10 (b), which relates to the computation of entire net income on a combined return, stated, in part: "Capital losses should be offset against capital gains, contributions should be deducted and intercorporate profits should be treated in computing combined entire net income as if each corporation in the group had filed its Federal income tax return on a separate basis. However, corporations may offset capital losses against capital gains, deduct contributions and defer intercorporate profits as if the corporations in the group had filed a consolidated Federal income tax return, provided the group of corporations included in the combined report consistently compute combined entire net income by this method. Changes in the method of computing combined entire net income under this subdivision may be made only with the approval of the Commissioner."

59. In its answer, the Division affirmatively states that members of a New York combined group "compute their combined ENI by: (1) first calculating an amount for the ENI of the individual members of the combined group as if those members filed separate New York returns; and (2) then by totaling those individual amounts."

60. The Division further affirmatively states in its answer that for the period at issue, on Nordstrom's New York combined franchise tax returns, petitioner "computed NIHC's proforma or 'as if' FTI by including an amount, $186,333,334.00 for NIHC's gain from the distribution of the Marks . . . which flowed through to its computation of NIHC's individual ENI and, therefore, Nordstrom, Inc.'s computation of its combined ENI."

61. NIHC did not have its own independent nexus with New York State and, therefore, did not have the obligation to file its own separate company franchise tax return in FYE 01/31/1999, or in later years.

Credit Card Receivables Securitization Background and Bad Debt Issue

62. FSB, which is a federal savings bank, issues Visa-branded credit cards (that can be used at any location that accepts Visa-branded cards) and private label credit cards (that can only be used at Nordstrom stores) to consumers (cardholders).

63. When a cardholder makes a purchase using an FSB-issued card, a receivable is created through which the cardholder owes FSB the amount of the purchase.

64. Shortly after the consumer purchase transaction, FSB settles the transaction with the merchant, whether the merchant is Nordstrom (for the private label credit cards) or some other business (for the Visa-branded credit cards).

65. FSB sells 90% of its Visa-branded credit card receivables and 100% of its private label credit card receivables to NCI at face value as part of an asset-based securitization of the receivables, which is a common practice. Companies securitize receivables for funding, to increase overall liquidity, and to generate proceeds from their assets. The securitization process occurs as described in the following paragraphs.

66. NCI immediately transfers the receivables to its wholly-owned subsidiary, Nordstrom Credit Card Receivables II LLC (NCCRII), an entity that is disregarded for federal and New York tax purposes.

67. NCCRII then transfers the receivables to Nordstrom Credit Card Master Note Trust II, which then sells securities that represent an interest in the pool of receivables to third parties.

68. When cardholders make payments on their credit card accounts, the payments are received by FSB and the amounts collected, minus fees owed to FSB, are remitted to NCCRII.

69. Sometimes, cardholders cease making payments (i.e., default) on their accounts and the accounts are eventually determined to be uncollectible.

70. An agreement between NCI and Nordstrom (the Recourse Agreement) requires NCI to transfer the expenses for uncollectible receivables to Nordstrom on a monthly basis.

71. The Recourse Agreement states the parties' reason for entering into the agreement as follows: "The parties now desire to enter into this Recourse Agreement to ensure the Bank's safety and soundness."

72. The Recourse Agreement states:

> "Monthly Bad Debt Transfer Nordstrom shall bear all expense arising due to uncollectible debt in NCI's possession under the Operating Agreement. Each month, NCI shall transfer to Nordstrom all expense arising due to bad debt which is in NCI's possession under the Operating Agreement. The amount transferred hereunder shall be referred to as the 'Bad Debt Expense' and shall be determined based on the procedure set forth in Exhibit 1 attached to this Amendment, entitled 'Approved According Treatment: Propriety Bad Debt'. After such transfer, Nordstrom shall own all right, title and interest in such uncollectible debt."

73. Expenses for uncollectible receivables (bad debts) are deductible pursuant to IRC § 166, so long as all requirements for deductibility are met.

74. On its federal tax return for FYE 01/31/2009, Nordstrom took a bad debt deduction in the amount of $112,000,620.00 and related entity FSB took a bad debt deduction in the amount of $7,266,491.00, for a total bad debt deduction taken by the group of $119,267,111.00.

75. On its federal corporate income tax returns for each year at issue (filed on a consolidated basis), Nordstrom took a deduction for bad debt expense.

76. According to the parties' stipulation of facts, the Internal Revenue Service (IRS) "audited the bad debt expenses on those returns and did not make any adjustments to them." A copy of IRS form 886-A Issue Resolution Agreement for the prior year, FYE 01/31/2009, was admitted into the record as an attachment to the joint stipulation of facts, and states, in part, that "given that the remaining receivables may not be collected at an earlier time, it is concluded that the methodology used for the write off of credit card receivables should be accepted as one that is materially correct." The Issue Resolution Agreement lists the "Agreed Return Amount" as $119,267,110.00. The Issue Resolution Agreement identifies the issue as "Bad Debt Expense" and lists the "Entity for which this issue pertains" as "Nordstrom, Inc."

77. At the hearing, the Division's witness confirmed that the various agreements regarding the credit card receivables securitization arrangements that were in place during petitioner's prior audit (which included FYE 01/31/2009) continued to be in place during the years at issue.

78. The annual deduction amounts for bad debt expenses reflected by Nordstrom in its computation of federal taxable income are as follows: FYE 02/30/2010: $195,036,086.00 (Stip. Ex. 7E0013); FYE 01/29/2011: $194,038,316.00 (Stip. Ex. 7F0020); and FYE 01/28/2012: $133,550,384.00

79. On its New York State franchise tax return for each year at issue, Nordstrom reflected the bad debt expenses as reported on its federal corporate income tax returns for the respective years.

80. The Division disallowed Nordstrom's bad debt deduction as an "above-the-line" adjustment. The Division informed Nordstrom that it did not disallow the adjustment on the basis of exercising discretion to correct a distortion.

81. With respect to the disallowance of Nordstrom's bad debt deduction, the Division's workpapers do not reference IRC § 166. Instead, they reference IRC § 162.

82. When questioned regarding the propriety of the bad debt deduction, the Division's auditor testified as follows:

> "Q: Okay. And if I'm understanding correctly, you're stating when it comes to the bad debt you aren't stating that no one owns the bad debt, you're just stating that Nordstrom Inc. can't claim the bad debt and that it's misplaced.
>
> A: Correct, it is misplaced. It's a valid deduction and it should be on either Nordstrom Inc. or NCI depending on where the receivable is and the securitization arrangement.
>
> So it's a valid deduction they just determined you know, so many days or whatever policies, terms are in the agreement. If it's a bad debt, it's a bad debt. The misplacement of it is the concern of the problem here."

83. Pursuant to 20 NYCRR 3000.15 (d) (6), petitioner submitted 17 proposed findings of fact.[5] In accordance with State Administrative Procedure Act § 307 (1), proposed findings of fact 1 through 3, 5, 11, 13, and the second proposed finding of fact numbered 15 are supported by the record, and have been consolidated, condensed, combined, renumbered and substantially incorporated herein. Proposed finding of fact 4 has been accepted in part and rejected in part to remove terms of an agreement pertaining to another taxpayer not a party to this proceeding. Proposed findings of fact 6 through 10, 12, 14, the first proposed finding of fact numbered 15, 16, and 17 have been modified to more accurately reflect the record and/or accepted in part and rejected in part as conclusory, argument, irrelevant, repetitive, and/or not supported by the

[5] Petitioner's proposed findings of fact are numbered 1 through 17 and contain two separate paragraphs of

record; to the extent accepted they have been consolidated, condensed, combined, renumbered and substantially incorporated herein, as modified.

CONCLUSIONS OF LAW

A. The first issue to be resolved is whether the Division improperly denied petitioner's request to remove from its computation of taxable income NIHC's income from the deferral of intercorporate profits as reported on its combined returns for the years at issue.

New York State imposes an annual tax on all corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property or maintaining an office in the State (***see*** Tax Law § 209). During the years at issue, corporations computed their article 9-A tax liability on the greatest of four alternative bases, one of which was ENI (***see*** Tax Law former § 210 [1] [a-d]). As relevant here, petitioner computed its tax liability based on ENI, which is generally the same as the taxpayer's federal taxable income with certain modifications (***see*** Tax Law former §§ 208 [9], 210 [1] [a]).

The starting point for determining a corporation's ENI is its federal taxable income (***see*** Tax Law § 208 [9]). Because New York's computation of ENI is based on federal taxable income, the method of accounting used in computing taxable income for federal purposes, i.e., the timing of income and deductions and periods of accounting, is used in computing ENI (***see*** 20 NYCRR 2-2.1).

The Tax Law further recognizes that exceptions to this general rule may be necessary and grants the Division the authority to determine the taxable year or period in which an item of income or deduction must be included (***see id.***). Specifically, the Division's regulations provide:

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proposed findings of fact each numbered 15.

> "The accounting method or basis on which entire net income is to be computed must be the same as the taxpayer's method of accounting for Federal income tax purposes. However, when the Commissioner of Taxation and Finance deems it necessary in order to properly reflect the entire net income of the taxpayer, it may determine the taxable year or period in which any item of income or deduction must be included, without regard to the method of accounting used by the taxpayer" (20 NYCRR 2-2.1[a]).

Similarly, section 3-2.8 of the Division's regulations regarding methods of computing tax under article 9-A provides:

> "In general, the method of accounting used in computing taxable income for Federal income tax purposes is used in computing entire net income. However, whenever the Commissioner deems it necessary in order properly to reflect the entire net income of the taxpayer, the Commissioner may determine the taxable year or period in which any item of income or deduction shall be included, without regard to the method of accounting used by the taxpayer for Federal income tax purposes" (20 NYCRR 3-2.8; ***see also*** Tax Law § 208 [9] [d]).

For federal income tax purposes, the method of accounting used by petitioner to compute its federal taxable income from the intercompany transaction between NIHC and N2HC was to defer the $2.8B gain over a 15-year period, beginning with the FYE 1/31/1999. Under this method, on its federal consolidated returns, petitioner included $186,133,334.00 of NIHC's income in each year of the 15-year period, including each of the years at issue.

Petitioner filed a federal consolidated return with its subsidiaries, including NIHC and N2HC, for FYE 1/31/99 (the year of the intercompany transaction between NIHC and N2HC) and for each of the years thereafter up to and including the years at issue. The parties in the present matter stipulated that under federal regulations relating to consolidated returns, the gain from the intercompany transaction between NIHC and N2HC was to be deferred over 15 years (***see*** 26 CFR § 1.1502-13). The 15-year period corresponded to N2HC's amortization deduction of the value of the right to license the trademarks (***see*** 26 USC § 197). Under the federal rules, for the 15 years starting with FYE 1/31/99, on the federal consolidated returns filed by petitioner, which included both N2HC and NIHC, NIHC recognized income following the amortization schedule N2HC was required to use (i.e. 1/15th per year for 15 years), resulting in NIHC including $186,133,334.00 in income each year.

For federal purposes, the timing rules for taking into account items of income, gain, deduction and loss of members from intercompany transactions is contained in Treasury Reg. § 1.1502-13 (26 CFR § 1.1502-13). That regulation specifically states, "[t]he timing rules of this section are a *method of accounting* for intercompany transactions . . . . To the extent the timing rules of this section are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of this section control" (26 CFR § 1.1502-13 [a] [3], emphasis added). The parties stipulated that under the federal regulations, the deferral of NIHC's gain over the 15-year period was required, and petitioner reported 1/15 of the income from the intercompany transaction each year. Since petitioner's reporting of the NIHC income over 15 years was its method of accounting for federal income tax purposes, it was required to use that same method of accounting for New York State purposes (20 NYCRR 2-2.1 [a]; 3-2.8). This is what petitioner initially did on its New York State returns for the years at issue, including a portion of the deferred income in each year, as it did on its federal returns. Petitioner now wishes to remove that income from its calculation of ENI for the years at issue.[6] The Division correctly determined that consistent with its federal method of accounting, petitioner was required to include the deferred income in computing its ENI for the years at issue, and its denial

[6] It is noted that although petitioner contends that it should not have included the income from the intercompany transaction in its returns for the years at issue, petitioner did not file amended returns adjusting the NIHC income as reported in its original returns for these years.

of petitioner's request to remove the income as reported in the years at issue was not erroneous. Additionally, the Division's disallowance of petitioner's 20% reduction of the NIHC income for FYE 1/30/10 was proper.

B. Petitioner incorrectly argues in its reply brief that the Division raised the method of accounting argument for the first time in its post-hearing brief. A review of the Division's audit report shows that the Division's rejection of petitioner's argument regarding the timing of the § 311 (b) gain was based, in part, on the method of accounting rules:

> "The representative presented that the NIHC 311(b) gain should have all been recognized in 1999 and that an adjustment was required to eliminate the deferred gain in each period of this audit cycle. The representative further asserted that the deferral of the gain was incorrectly reported in ENI in all prior audit periods. The taxpayer representative reference to Regulation Section 3-2.2(d) is misplaced as this section of the law is primarily referring to separate reporting. While it acts as the starting point of the computation of combined ENI, Tax Law Section 208(d) and Regulation Section 3-2.8 permits use of the same method of accounting used for Federal income tax purposes."

Additionally, the Division's auditor testified that during the audit the Division tried to establish a consistent method of accounting with petitioner's federal treatment of the gain and expenses related to the intercompany transaction. The record thus establishes that the Division's determination was based, in part, on the rules regarding the method of accounting and this was not a new argument raised by the Division after the hearing.

C. Petitioner contends that it incorrectly reported the pro-rated § 311 (b) gain from the intercompany transactions between NIHC and N2HC on its New York returns for the years at issue and that the Division's regulations "require" it to compute the group's combined ENI "as if" it had filed separate returns for federal purposes. Petitioner argues that in computing its ENI on its New York combined reports for the years at issue, it should have computed its federal taxable income "as if" each member of the group had filed its federal income tax returns on a separate basis. According to petitioner, if it had filed its federal returns on a separate basis, the entire gain from the intercompany transaction would have been reported in 1999, a year in which NIHC was not a New York taxpayer.

In support of its argument, petitioner relies on the "as if" separate language contained in 20 NYCRR 3-2.2 and 3-2.10 (b). Specifically, petitioner relies on one sentence in subsection (c) of 20 NYCRR 3-2.2, which provides that "[e]ach corporation included in a Federal consolidated group must compute its Federal taxable income for purposes of article 9-A of the Tax Law as if such corporation had computed its Federal taxable income on a separate basis for Federal income tax purposes." Petitioner additionally relies on the portion of the language in 20 NYCRR 3-2.10 (b) which provides that "intercorporate profits should be treated in computing combined ENI as if each corporation in the group had filed its Federal income tax return on a separate basis." Based on that language, petitioner argues that it improperly included NIHC's $186,133,334.00 deferred income during the years at issue, contending that in computing its federal taxable income for article 9-A, it should have computed its federal taxable income "as if" it had been computed on a separate basis for federal income tax purposes. According to petitioner, had it filed its federal returns on a separate basis, NIHC "would not have applied the 15-year deferral required by the consolidated return rules and, instead, would have recognized the full $2.8B of income on January 31, 1999."[7]

Petitioner's interpretation of the "as if separate" phrase in 20 NYCRR 3-2.2 (c) and 3-2.10 (b) ignores the full language of 20 NYCRR 3-2.2, as well as the provisions of Tax Law §

[7] The parties stipulated that for federal purposes, the timing for NIHC to recognize the $2.8B of realized income was controlled by whether it and N2HC were included in the same federal consolidated return (***see*** findings

208 (9) (d) and 20 NYCRR 3-2.8. The "as if separate" language contained in those regulations must be read in the full context of the other language in those sections, and with the entire provisions of article 9-A of the Tax Law and regulations promulgated thereunder. Statutory and regulatory language must be "construed as a whole, and all parts of an act are to be read and construed together" (McKinney's Cons Laws of NY, Book 1, Statutes § 97). All parts of the statutory and regulatory language "must be harmonized with each other as well as with the general intent of the whole statute, and effect and meaning must, if possible, be given to the entire statute and every part and word thereof" (McKinney's Cons Laws of NY, Book 1, Statutes § 98).

The first paragraph of regulation section 3-2.2, definition of entire net income, specifically states that the computation of federal taxable income "is subject to the adjustments, deductions and modifications provided in this subpart" (20 NYCRR 3-2.2 [a]). The "as if" computation of federal taxable income described in subsection (c) is thus subject to the adjustments, deductions and modifications contained within subpart 3-2 of the regulations (***see*** 20 NYCRR 3-2.2).

As discussed above, subpart 3-2.8 of the Division's regulations specifically states that, generally the method of accounting used in computing taxable income for federal income tax purposes is used in computing entire net income for article 9-A, and "whenever the Commissioner deems it necessary in order properly to reflect the entire net income of the taxpayer, the Commissioner may determine the taxable year or period in which any item of income or deduction shall be included, without regard to the method of accounting used by the taxpayer for Federal income tax purposes" (20 NYCRR 3-2.8; ***see also*** Tax Law § 208 [9] [d]).

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of fact 52 and 54).

In this case, the Division properly determined that the inclusion of the deferred income from the intercompany transaction was consistent with petitioner's federal method of accounting. The Division was also authorized to require the deferred income to be included in the computation of ENI in the years at issue, regardless of petitioner's computation of federal income on an "as if" separate basis. Had petitioner not included the deferred income in the years at issue, the Division had the authority to determine that the income should have been included in those years, and thus its determination that petitioner could not change that reporting after the fact was not erroneous.

D. Petitioner's reliance on ***Matter of Univisa, Inc.*** (Tax Appeals Tribunal, September 20, 2007) in support of its argument that it should not have reported the income from the intercompany transaction between NIHC and N2HC during the years at issue is misplaced. ***Matter of Univisa, Inc.*** dealt strictly with a net operating loss (NOL) deduction claimed by a separate entity filer. The sole issue addressed in that matter was whether Univisa, Inc. (Univisa), a separate New York filer, was entitled to an NOL deduction reattributed to it from a subsidiary in a prior year pursuant to federal consolidated return regulations. Univisa filed federal consolidated corporation income tax returns with its affiliated entities beginning with the year ended December 31, 1989 and including the audit period (periods ended December 31, 1996 and May 16, 1997). It began business in New York on July 3, 1989, and began filing separate New York State general business corporation franchise tax returns beginning with the year ended December 31, 1989 and for each year of the audit period. Univisa's subsidiary, Univisa Sports Holding Inc. (USHI), filed as part of the federal consolidated group with Univisa for the years ended December 31, 1989, 1990 and 1991 and reported federal NOLs on a separate company basis per the federal consolidated return. During the years ended December 31, 1989, 1990 and 1991, USHI's only business activity was its investment in a New York State partnership. USHI filed New York State general business corporation franchise tax returns beginning with the year ended December 31, 1989. For the years ended December 31, 1989, 1990 and 1991, USHI reported the same amount of NOLs to New York State as reported on its federal consolidated returns. Univisa filed a federal election with its 1991 U.S. corporation income tax return to reattribute all of the losses sustained by USHI to itself. USHI did not conduct any business activities after 1991. For the years ended December 31, 1992 and 1993, USHI filed New York State forms CT-245 (maintenance fee and activity return) disclaiming tax liability and paying only a maintenance fee. Following the 1993 tax year, USHI no longer filed in New York State and was listed as inactive on the consolidated federal returns of Univisa and subsidiaries through the taxable year ended May 16, 1997. Univisa's federal income tax returns for the years ended December 31, 1995 and 1996 and May 16, 1997 were audited and Univisa was permitted to use USHI's reattributed losses in the years that were audited for federal purposes. Univisa utilized the NOLs reattributed from USHI to offset the income it reported on its New York State Corporation Franchise Tax Return for the years ended December 31, 1996 and May 16, 1997, and the Division disallowed Univisa's use of these NOLs for those years.

The Tax Appeals Tribunal sustained the Division's disallowance of the NOLs, noting that the Division's regulations specifically provide for a separate-company computation of the New York NOL of a corporation joining in federal consolidated returns but filing separately in New York, as follows:

> "A taxpayer is allowed a deduction similar to that allowed under section 172 of the Internal Revenue Code . . . in computing entire net income for purposes of

> article 9-A. A corporation which reports as part of a consolidated group for Federal income tax purposes *but on a separate basis for purposes of article 9-A* computes its net operating loss and its net operating loss deduction as if it were filing on a separate basis for Federal income tax purposes" (***Matter of Univisa, Inc.***, quoting 20 NYCRR 3-8.1 [a], emphasis added).

Matter of Univisa, Inc., is clearly distinguishable from the present matter. Univisa was a separate filer for New York purposes, whereas petitioner here filed combined New York returns for the years at issue including both NIHC and N2HC in the group. Moreover, the specific regulation on which the Tribunal based its decision applied strictly to NOLs and does not apply here. Rather, the regulations governing the method of accounting and timing rules for the inclusion of income in computing ENI on combined returns are controlling here. Those regulations require that petitioner use the same method of accounting in computing taxable income for ENI as that used for federal income tax purposes, unless the Commissioner determines that another method is necessary (***see*** 20 NYCRR 2-2.1 (a); Tax Law § 208 [9]). In this case, petitioner included the deferred income in the calculation of ENI for the years at issue, consistent with its federal method of accounting. The Division properly determined that the income was correctly included by petitioner in its computation of ENI.

E. Petitioner also argues that it "did not qualify to use the elective method" in 20 NYCRR 3-2.10 (b), which provides that for computing ENI on a combined report "corporations may … defer intercorporate profits as if the corporations in the group had filed a consolidated Federal income tax return, provided the group of corporations included in the combined report consistently compute combined entire net income by this method." According to petitioner, in order to defer intercorporate profits as if the corporations in the group had filed a consolidated federal income tax return, the regulation requires that the group consistently compute combined

ENI by this method *year over year*. Petitioner contends that because it filed on a separate entity basis for FYE 1/31/99 and NIHC was not a New York filer in that year, it has not consistently computed ENI by this method.

The Division, on the other hand, argues that petitioner consistently computed combined ENI using this method, contending that petitioner established a consistent method of accounting for federal purposes by deferring the NIHC $2.8B gain over 15 years matching the amortization deduction of N2HC, that petitioner's deferral of the intercorporate profits as reported on the combined returns for the period at issue was consistent with its reporting of the deferred gain on the federal consolidated returns, and was consistent with the method used in the prior closing agreements. The Division further argues that after the closing agreements were finalized for the prior audit periods, petitioner reported the $186,133,334.00 deferred gain on its original New York combined returns for the periods 2/1/2009 through 1/28/2012 (less a 20% reduction for FYE 1/30/2010) and that when filing its New York State combined return for the period ending 1/30/2010, petitioner admitted in their original filing that "[f]or purposes of completing the New York Franchise Tax Return for the year ended 1/30/2010 the combined reporting of NIHC, Inc. with N2HC, Inc. has been included in a manner consistent with the closing agreement for the preceding tax year."

Ultimately, the disagreement between the parties as to whether "the group of corporations included in the combined report consistently compute[d] combined entire net income" within the meaning of the regulation (20 NYCRR 3-2.10 [b]) is a matter of statutory and regulatory construction. When construing a statute, the primary focus is on the intent of the Legislature in enacting the statute (McKinney's Cons Laws of NY, Book 1, Statutes § 92 [a]; ***see Matter of***

Sutka v Connors, 73 NY2d 395 [1989]; ***Matter of American Communications Tech. v State of New York Tax Appeals Trib.***, 185 AD2d 79 [3d Dept 1993], ***affd*** 83 NY2d 773[1994]). The language of the statute "is the clearest indicator of legislative intent and courts should construe unambiguous language to give effect to its plain meaning" (***Matter of DaimlerChrysler Corp. v Spitzer***, 7 NY3d 653, 660 [2006]). The statutory language "must be read in [its] context, and words, phrases, and sentences of a statutory section should be interpreted with reference to the scheme of the entire section" (McKinney's Cons Laws of NY, Book 1, Statutes § 97). These principles of statutory construction also apply to the interpretation of regulations (***see Matter of Cortland-Clinton v NYS Dept. of Health***, 59 AD2d 228 [4th Dept 1977]).

In a case such as this where the tax was properly imposed on the income as reported by petitioner in the first instance and petitioner now seeks to recompute its ENI and exclude NIHC's deferred income from the intercorporate transaction, petitioner bears the burden of proof (***see*** Tax Law § 1089 [e]; ***Matter of John Grace & Co., Inc.***, Tax Appeals Tribunal, September 13, 1990). Petitioner argues that it improperly deferred NIHC's income from the intercorporate transaction, contending that "the sole requirement for a combined group of companies to use the Consolidated Deferral Method is that the group 'consistently' use that method *year over year*" (emphasis added). However, petitioner's argument improperly inserts a temporal requirement that is not contained in the regulation. Contrary to petitioner's argument, the regulation does not require that the same method be used over a period of years. The regulation for computing ENI on a combined report states:

> "Capital losses should be offset against capital gains, contributions should be deducted and intercorporate profits should be treated in computing combined entire net income as if each corporation in the group had filed its Federal income tax return on a separate basis. However, *corporations may offset capital losses*

> *against capital gains, deduct contributions and defer intercorporate profits as if the corporations in the group had filed a consolidated Federal income tax return, provided the group of corporations included in the combined report consistently compute combined entire net income by this method*. Changes in the method of computing combined entire net income under this subdivision may be made only with the approval of the Commissioner" (20 NYCRR 3-2.10 [b], emphasis added).

Petitioner's argument that it could only defer the intercorporate profits in computing ENI if it had used this method year over year reads into the regulation a yearly requirement that simply does not exist.

It is a fundamental principle of statutory construction that words should not be expanded to enlarge their meaning to something which the Legislature could easily have expressed but did not, and new language cannot be imported into a statute to give it a meaning not otherwise found therein (***see*** McKinney's Cons Laws of NY, Book 1, Statutes § 94; ***see also Rossi v Nyquist***, 59 AD2d 1001 [3d Dept 1977]). Furthermore, these rules of statutory construction apply with equal force in the administrative regulatory text (***see Andryeyeva v New York Health Care, Inc.,*** 33 NY3d 152 [2019]; ***Matter of Unicredit S.P.A.***, Tax Appeals Tribunal, May 19, 2015, citing ***Matter of Cortland-Clinton, Inc. v New York State Dept. of Health***, 59 AD2d 228, 231).

Even if petitioner's argument that consistent means the same method must be used over a period of years was correct, petitioner's reporting history reflects that it did include the gain starting with the first time NIHC was included in the combined return in FYE 1/31/09, through and including the years at issue. From the first year that petitioner filed combined returns including both NIHC and N2HC through and including the years at issue, the members of the group computed ENI in a consistent manner reflecting the deferred income and amortized deduction from the intercompany transaction. Indeed, there is no dispute that NIHC included the annual deferral amount in the computation of combined ENI on the New York combined returns for each year it was included in Nordstrom's New York combined group. Pursuant to the Division's regulations, petitioner would need the Commissioner's approval in order to change that method of computing combined ENI (***see*** 20 NYCRR 3-2.10 [b]).

Petitioner's contention that it must go back to 1999, the year of the transaction between NIHC and N2HC, to determine whether a consistent method was used to compute combined ENI is flawed. There was no computation of combined ENI in 1999 because there was no combined return. Petitioner argues that because NIHC was not a New York filer in the transaction year and a separate entity return including only Nordstrom was filed in that year, that the group did not use a consistent method to calculate combined ENI to include NIHC's deferred intercorporate profits, and petitioner should therefor now go back in time and remove the deferred income from each year where it filed combined returns including NIHC's income. This argument is without merit. Since petitioner did not file a combined return in 1999, there was no "group of corporations" computing combined ENI by *any* method in the transaction year.

Furthermore, petitioner's argument lacks merit because it ignores the statutory definition of ENI and would render the provisions of Tax Law § 208 (9) (d) and 20 NYCRR 2-2.1 (a) and 3-2.8 meaningless (***see e.g. Matter of Helio***, Tax Appeals Tribunal, July 2, 2015 [rejecting interpretation that would make a word in the statute meaningless]). As noted above, regulation 3-2.10 must be read in pari materia with Tax Law § 208 (9) (d) and 20 NYCRR 2-2.1 (a) and 3-2.8 (***see*** McKinney's Cons Law of NY, Book 1, Statutes §§ 96, 97, 98; ***Matter of 1605 Book Ctr. v Tax Appeals Trib. of State of N.Y.***, 83 NY2d 240, 244 [1994], ***cert denied*** 513 US 811 [1994]). The language of 20 NYCRR 3-2.10 (b) must be construed together with the statutory definition of ENI (***see Matter of GKK 2 Herald LLC***, Tax Appeals Tribunal, May 10, 2018 ["we use the statutory definitions of terms used in the regulation in our analysis"]). The statutory definition of ENI clearly states that whenever necessary in order to properly reflect the ENI of any taxpayer, the Commissioner may determine the year or period in which any item of income or deduction shall be included. Given the statutory definition of ENI, petitioner's argument that to be "consistent" it must use the same method as it used on January 31, 1999 must be rejected.

A more natural reading 20 NYCRR 3-2.10 (b), supported by the actual words of that regulation, is that when filing a combined report, the corporations in the group compute their ENI consistently (i.e. matching intercorporate profits with deductions). Such a reading is in line with the statutory definition of ENI, which gives the Commissioner discretion to determine the year or period in which any item of income or deduction shall be included in order to properly reflect ENI (***see*** Tax Law § 208 [9] [d]) and the corresponding regulations. Such interpretation is also consistent with the stated purpose of the federal regulations governing the method of accounting and timing rules for intercompany transactions that are to be followed for computing ENI on State combined returns unless determined otherwise by the Commissioner (***see*** 20 NYCRR 2-2.1 [a]; 26 CFR § 1.1502-13 ["purpose is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income (or consolidated tax liability)"].

From the first year that the Nordstrom Group filed combined returns including both NIHC and N2HC (FYE 1/31/2009 amended return) through and including the years at issue, the corporations in the group computed ENI in a consistent manner, including both NIHC's deferred income and N2HC's amortized deduction from the intercompany transaction. In accordance with the Division's regulations, petitioner would need the Commissioner's permission to now change that method (see 20 NYCRR 3-2.10 [b]). Petitioner has not met its burden of proving that the Division's denial of permission for it to change its method was erroneous.

While I agree with the Division's argument that the group of corporations in petitioner's combined return computed ENI consistently by including the NIHC gain and N2HC's amortized expense, and that petitioner's method was consistent in the years at issue with its federal returns, I disagree with Division's argument that petitioner was required to be consistent with the method used in the prior closing agreements. The language of the closing agreements specifically state that they do not apply to other periods. I also disagree with the Division's argument that petitioner made a material misrepresentation of fact in the prior closing agreements. The Division contends that by now arguing that it should not have deferred the gain from the intercompany transaction and should have, instead, reported the full gain in 1999, petitioner made a material misrepresentation of fact in the prior closing agreements such that it should now be required to use the same deferral method as used in the closing agreements. Contrary to the Division's argument, there is no evidence that petitioner misrepresented any facts nor does petitioner seek to change facts from the closing agreements. The facts remain undisputed regarding the transaction date and petitioner's deferral of the income on its federal returns. Rather, petitioner changed its legal theory sometime during the audit, raising the argument that although it reported the deferred gain in the years at issue, it should have reported it in the transaction year. This is not a misrepresentation of fact but instead a legal argument.

F. The Division also argues that petitioner must report the NIHC income in a manner consistent with the court's decision in ***NIHC, Inc. v Comptroller of Treasury*** (439 MD 668 [2014]). While such argument is moot, based on the discussion above, the case will be addressed herein because the facts are nearly identical and both parties discuss it in their briefs. Although a decision from a court of another state is not controlling, it can be persuasive if the states have a similar purpose in their statutory schemes (***see All Seasons Resorts, Inc. v Abrams***, 68 NY2d 81[1986]). However, as discussed below, the Maryland Court of Appeals did not ultimately decide on the specific question at issue here regarding the proper timing for reporting the § 311 (b) gain.

NIHC, Inc. v Comptroller involved the same January 1999 intercorporate transaction between NIHC and N2HC as here. Similar to the facts stipulated by the parties here, according to the analysis of Nordstrom's tax consultant in ***NIHC, Inc. v Comptroller***, under the federal tax code the distribution of the license agreement from NIHC to N2HC was considered the distribution of appreciated property that would be recognized as a gain to NIHC under § 311 (b) of the Internal Revenue Code, 26 USC § 311 (b) (***see NIHC, Inc. v Comptroller of Treasury*** at 675). According to that analysis, NIHC was required under federal tax law to recognize a gain to the extent that the market value of the licensing agreement exceeded the book value of the dividend (***id.***). In addition, the dividend created a basis in N2HC that was subject to amortization under federal tax law. Accordingly, Nordstrom was required to report the value of the distribution as a gain by NIHC, as well as the amortization of N2HC's basis, on Nordstrom's consolidated federal tax return for the fiscal year that ended on January 31, 1999 (***id.***). Nordstrom filed a consolidated federal return with its subsidiaries, including NIHC and N2HC.

Under federal regulations relating to consolidated returns, the gain from the license distributed by NIHC to N2HC was to be deferred over 15 years because the transaction was between affiliated corporations (***id.*** at 676). For tax years 2002 and 2003, the years at issue in the Maryland case, Nordstrom's consolidated federal returns reported income to NIHC in the amount of $186,133,333.00, and a deduction for amortization expense for N2HC in an identical amount (***id.***).

NIHC and N2HC filed separate income tax returns in Maryland for 2002 and 2003 that showed no income apportioned to Maryland from the transactions involving the Nordstrom trademarks. In its 2002 and 2003 Maryland returns, NIHC reported the deferred gain shown on the consolidated federal returns, reporting Maryland modified income of $186,240,824.00 and $186,128,851.00 for 2002 and 2003 respectively, but did not apportion any of that income to Maryland (***id.***).

Following an audit, the Maryland Comptroller of Treasury (Comptroller) issued assessments against Nordstrom, NIHC and N2HC based on the position that income-shifting in the form of trademark royalty expenses had resulted in an underpayment of the companies' Maryland income tax (***id.*** at 677). The Comptroller's Hearings and Appeals Section upheld the assessments and the taxpayers appealed to the Maryland Tax Court (Tax Court) (***id.***). During the Tax Court hearing, Nordstrom's former Vice President of Tax, Greta Sedlock, testified that she would have completed the 2002 and 2003 Maryland returns differently based upon a letter she had received from tax authorities in New Jersey in 2005, a state that, like Maryland, requires separate company reporting, and believed that because NIHC filed separate returns from its affiliated corporations, it should have reported the entire gain from the inter-company transactions on its 1999 Maryland return when the § 311 (b) gain was recognized. Similar to petitioner's argument here, Ms. Sedlock testified that she now believed the deferral of the gain over 15 years was only appropriate for the consolidated returns filed under federal law (***see Nordstrom, Inc. v Comptroller of Treasury***, 2008 WL 4754843 [2008]).

The Tax Court viewed the "dispositive issue" as whether there was a sufficient nexus between the two subsidiaries and Maryland to impose Maryland income tax in accordance with the Commerce Clause and Due Process Clause of the United States Constitution (***id.***). The Tax Court affirmed the assessments, determining that NIHC and N2HC lacked real economic substance as separate business entities and holding that the activities of the subsidiaries must be considered the activities of Nordstrom, which has a nexus with Maryland (***id.***).[8]

NIHC appealed the Tax Court decision and the Circuit Court for Baltimore County noted that the sole issue decided by the Tax Court was whether there was a sufficient nexus between Maryland and NIHC to allow taxation of NIHC's income by Maryland under the federal Constitution (***Nordstrom, Inc. v Comptroller of Treasury***, Circuit Court of Baltimore County, Nos. 03-C-08-012004 and 03-C-08-012005 [2009]). The Circuit Court held that the fact that NIHC lacked economic substance did not by itself resolve the question whether there was a sufficient constitutional nexus between its income and the State to satisfy the Federal Constitution and remanded the case to the Tax Court to address whether there was a constitutionally sufficient nexus between the § 311 (b) gain realized by NIHC and business activities in Maryland (***id.***). If so, the Circuit Court directed the Tax Court to analyze (1) whether the § 311 (b) gain constituted taxable income under Maryland tax law; and (2) whether

[8] No nexus issue was raised for the years at issue in the present matter.

the Maryland requirement of separate entity reporting would prevent taxation of the deferred § 311 (b) gain in the 2002 and 2003 tax years (***id.***).

On remand, the Tax Court upheld the assessment, holding that Maryland's taxation of the reported income was constitutional as it was not possible to separate the value of the trademarks, their licensing, and the gain recognized by NIHC from Nordstrom's business activities in Maryland (***see NIHC, Inc. v Comptroller of Treasury***, 439 MD at 680 [discussing Tax Court's Amended Memorandum decision]). The Tax Court also held that, because Nordstrom's nexus was attributed to NIHC, the income was taxable under Maryland law, and further that Maryland's requirement of separate entity income tax returns did not prohibit the taxing of the § 311 (b) gain, stating that "NIHC reported the deferred gains as Maryland modified income and the substance of the transaction does not prevent the taxing of income earned in the assessment years because of separate reporting requirements" (***id.***).

NIHC again appealed the Tax Court decision. The Circuit Court affirmed in part and reversed in part, agreeing with the Tax Court that there was a sufficient nexus of the reported income with Maryland and that the gain income was reasonably attributable to activities in Maryland and therefore taxable under the Maryland income tax law (***id.*** at 681). However, the Circuit Court reversed the assessment against NIHC, holding that Maryland's separate reporting requirement prohibited the Comptroller from assessing the deferred gain reported by NIHC for 2002 and 2003, which the court believed should have been reported with the rest of the gain when it was recognized in 1999 (***id.***).

The Comptroller appealed the Circuit Court decision to the Court of Special Appeals; NIHC did not cross-appeal, and in an unreported decision, the Court of Special Appeals reversed the Circuit Court judgment (***id.***). The Court of Special Appeals noted that the only issue before it was whether Maryland's separate reporting requirement prevented the taxation of the gain reported on NIHC's 2002 and 2003 returns and found that the Circuit Court had incorrectly focused on how the § 311 (b) gain should have been reported instead of whether it was taxable in the way it had in fact been reported (***id.***). The Court of Special Appeals reversed the Circuit Court, noting that it had not been presented with any law or authority that precluded Maryland from taxing income that was constitutionally taxable by Maryland and that was reported by the taxpayer as Maryland modified income on its tax returns (***id.***). The Court of Special Appeals declined to opine on the question of whether a corporation's § 311 (b) gain, which is constitutionally subject to taxation by Maryland, is reportable as Maryland modified income on a deferred basis under Maryland's requirement of separate entity income tax returns, where such deferred gain is reported on the corporation's consolidated federal income tax return (***id.***).

NIHC appealed, and the Maryland Court of Appeals affirmed the judgment of the Court of Special Appeals (***NIHC, Inc. v Comptroller of Treasury***). The Court stated that the only issue before it was whether the Maryland statutory requirement that corporate affiliates file separate returns prohibited the Comptroller from taxing the portion of that gain reported on NIHC's 2002 and 2003 returns (***id.*** at 684, 685). The Court agreed with the Court of Special Appeals' decision affirming the Tax Court's determination that Maryland's separate reporting requirement for corporations did not prohibit the Comptroller's assessment taxing NIHC's § 311 (b) gain on a deferred basis. The Court noted that in computing the assessment, the Comptroller used the figures for Maryland taxable income reported on NIHC's Maryland returns, which correlated with the figures for its federal taxable income reported on NIHC's federal returns for those years, "the 'starting point' for computation of its tax liability" (***id.*** at 686).

Similar to petitioner's argument here, the court described NIHC's argument as follows:

> "NIHC argues that Nordstrom should have re-computed a separate federal return for each of the affiliated companies for each of the years in question—called a "pro forma" federal return—and based its Maryland return for each year on the income shown on the corresponding pro forma federal return. NIHC argues that its pro forma federal returns—and thus its Maryland return as well—would have reported the entire § 311 (b) gain as income in 1999 and that NIHC should have reported no income from that gain on its pro forma federal returns and Maryland returns for 2002 and 2003" (***id.*** at 687).

The court noted, however, that "NIHC never completed any pro forma federal returns, did not amend its Maryland returns in that manner, and, based on the record in this case, did not embrace this manner of reporting its income until tax was assessed by the Comptroller, even though the corporate official in charge of its tax returns claimed to have come to a different conclusion as to how to report its income within the period for amending the returns" (***id.***).[9]

The court further stated:

> "As the Court of Special Appeals held, whether NIHC could have, or should have, reported the entire gain as income subject to Maryland income tax in 1999—in advance of the business activities of Nordstrom in Maryland in 2002 and 2003 that established the nexus with the income shifted to NIHC—is a separate question from whether the Comptroller could assess income actually reported by NIHC for those years" (***id.*** at 688).

The Court concluded:

> "There is no question that the income related to Nordstrom's activities in Maryland during 2002 and 2003 tax years was shifted in part to NIHC. The Comptroller assessed tax on that income as NIHC reported it on its tax returns for

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[9] Similarly, in the present matter, there is no evidence that petitioner filed amended returns for the years at issue embracing the method of reporting it argues it is required to use.

> those years. However, neither NIHC nor its affiliated corporations has amended their returns to reflect another way of reporting that income. Essentially, NIHC asks that, because it mistakenly neglected to report its entire gain and pay the appropriate tax on its 1999 Maryland return, it should be forgiven any tax liability on that income, even though it reported a portion of that income on its 2002 and 2003 returns. On the facts of this case, the separate reporting requirement does not eliminate the tax liability for the income reported, properly subject to tax, and not previously taxed. We hold that, on the record before the Tax Court, NIHC did not carry its burden of showing that the Comptroller's assessment was wrong" (***id.*** at 689).

Similar to NIHC's Maryland reporting, petitioner here included the NIHC deferred income in its calculation of ENI on its combined returns for the years at issue, and now seeks to remove such income from its computation. However, the Division's argument that petitioner must report the NIHC income in a manner consistent with the Maryland Court of Appeals' decision is flawed, because that court did not ultimately decide on whether the taxpayers were required to report the § 311 (b) gain on a deferred basis for state tax purposes when it is reported on a deferred basis on a consolidated federal return.

Indeed, the Court of Special Appeals specifically declined to opine on the question of whether a corporation's § 311 (b) gain is reportable as Maryland modified income on a deferred basis under Maryland's separate return requirement, where such deferred gain is reported on the corporation's consolidated federal income tax return. The Court of Appeals, in agreement with Court of Special Appeals, limited the issue to whether Maryland's statutory requirement for separate reporting prohibited the Comptroller from taxing the portion of the gain reported on NIHC's 2002 and 2003 returns.

Unlike ***NIHC v Comptroller***, the issue addressed here is whether the Division properly determined that petitioner was not entitled to remove from its combined returns for the years at issue NIHC's income from the deferral of intercorporate profits as originally reported.[10] Answering such question necessarily involves determining whether the § 311 (b) gain is properly reported on a deferred basis on petitioner's combined returns for the years at issue, a question not addressed by the Court of Appeals in ***NIHC v Comptroller***. As noted above, the Tax Law and regulations clearly provide that the accounting method on which ENI is to be computed must be the same as the taxpayer's method of accounting for federal income tax purposes, unless the Commission determines that an item of income or deduction be included in a different taxable year in order to properly reflect ENI (***see*** Tax Law § 208 [9] [d]; 20 NYCRR 2-2.1 [a], 3-2.8). In this case, under petitioner's method of accounting for federal income tax purposes, the income from the intercorporate transaction was included on a deferred basis. The Tax Law and regulations require petitioner to report the income on the same deferred basis for its combined returns as reported on the consolidated federal returns (***id.***).

G. The next issue to be addressed is the Division's disallowance of deductions for bad debt expenses. On its federal corporate income tax returns for each of the years at issue, filed on a consolidated basis, Nordstrom took a deduction for bad debt expense. On its New York State franchise tax return for each of the years at issue, Nordstrom reflected the bad debt expenses as reported on its federal corporate income tax returns. The Division disallowed the deduction for bad debt taken by Nordstrom on its returns for each of the years at issue. The

[10] Although, as noted, petitioner did not file amended returns reflecting the manner of reporting it claims it should have used, it raised the § 311 (b) issue with the Division prior to the issuance of the subject notice, as well as in the petition filed in this matter. As such, this issue is properly before the Division of Tax Appeals. If petitioner's argument herein had been successful, to the extent that such removal of the NIHC income resulted in an overpayment, any credit or refund resulting from the alleged improper inclusion of NIHC's income would be limited to the provisions of Tax Law § 1087 (f) because petitioner did not file an amended return or claim or credit for refund of overpayment.

Division stipulated that the disallowance was an "above-the-line" adjustment and was not based on its exercise of discretion to correct a distortion.

Deductions are a matter of legislative grace, and petitioner bears the burden of proving entitlement to the claimed deductions (***see New Colonial Ice Co. v Helvering***, 292 US 435, 440 [1934]; ***Matter of Grace v State Tax Commn.***, 37 NY2d 193, 195 [1975]; ***Moss v Commissioner,*** 135 TC 365 [2010]). As discussed below, petitioner has met its burden of proof to show that Nordstrom is entitled to the bad debt deduction claimed for the years at issue.

IRC (26 USC) § 166 provides, in relevant part, for a deduction for bad debts as follows:

"(a) General rule.-

> (1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.
>
> (2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of deduction.--For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

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(d) Nonbusiness debts.—

> (1) General rule.--In the case of a taxpayer other than a corporation—
>
> (A) subsection (a) shall not apply to any nonbusiness debt; and
>
> (B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.
>
> (2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

The corresponding Treasury Regulation provides, in part, as follows:

"(a) Allowance of deduction. Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

***

(c) Bona fide debt required. Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. . . ." (26 CFR § 1.166-1).

H. The Division asserts that Nordstrom did not qualify to take the deduction at the federal level and, therefore, the Division made an "above the line" adjustment to the company's computations. The Division does not dispute that the bad debt deduction was properly classified as a business bad debt deduction pursuant to IRC (26 USC) § 166. Instead, the Division argues that the bad debt deduction was claimed by the wrong entity, Nordstrom, and should have been claimed by either NCI or FSB, two entities that were not included in the New York combined returns for the years at issue.

As petitioner correctly notes, a corporation's franchise tax is based on its entire net income, which shall be presumably the same as its entire federal taxable income modified by specific additions or subtractions (***see Matter of Stewart's Shops Corp. v NY State Tax Appeals***

Trib., 172 AD3d 1789 [3d Dept 2019]; ***Matter of International Business Machines Corp. and Combined Affiliates***, Tax Appeals Tribunal, March 5, 2021). Nordstrom took the same bad debt deduction as it took on its federal consolidated returns, and such deduction was used in calculating its federal taxable income. The Division is not arguing that a specific modification applies to the deduction, but that Nordstrom was not the proper entity to take the deduction and hence the bad debt expense should not have been included in calculating Nordstrom's federal taxable income. However, the IRS audited the specific bad debt deduction for federal purposes and allowed such deduction for Nordstrom. Petitioner argues that the outcome of the federal audit is determinative for purposes of the bad debt deduction.

The Division argues that the federal audit did not address the specific issue at hand, contending that "[w]hen a taxpayer is subject to a federal audit, if that audit does not specifically address this issue at hand for New York State, the federal audit is not binding." However, the Division stipulated that the federal audit *did* address and accept the specific bad debt deductions (***see*** findings of fact 75 and 76). The precise language of the stipulation of facts is important to consider. Paragraph 69 of the stipulation of facts states, "[o]n its federal corporate income tax returns for each Year at issue (filed on a consolidated basis), Nordstrom, Inc. took a deduction for bad debt expense" (***see*** finding of fact 75). Paragraph 70 of the stipulation of facts states, "[t]he Internal Revenue Service audited the bad debt expenses on those returns and did not make any adjustment to them. A copy of the IRS form 886-A Issue Resolution Agreement is attached at Tab 9" (***see*** finding of fact 76). Although the attached Issue Resolution Agreement pertains only to FYE 1/31/09, the Division stipulated that the IRS audited and did not adjust the bad debt expenses "*on those returns*" referring to the returns for the years at issue, as stated in the preceding paragraph of the stipulation of facts. The Division thus stipulated that the IRS audited and did not adjust the deduction for bad debt expense taken by Nordstrom for FYE 1/31/09 and also for the years at issue. The Division is bound by its stipulation of facts and cannot now argue contrary to those facts (***see Matter of Amherst Cablevision, Inc.***, Tax Appeals Tribunal, March 7, 1996).

The Division further argues that the IRS audit of the bad debt expense on petitioner's returns should be disregarded, claiming that the federal Issue Resolution Agreement did not specifically address which entity within the federal consolidated group the bad debt expense was attributable to, and further that the IRS was not concerned which specific entity within the group the bad debt expense should be claimed by, since all the companies were in one federal consolidated return.

However, the Division's argument is not supported by the facts or the law. First, contrary to the Division's argument, the Issue Resolution Agreement addressing the bad debt deduction clearly identifies which entity the bad debt expense was attributable to. The Issue Resolution Agreement specifically lists the "Entity for which this issue pertains" as "Nordstrom, Inc." The Issue Resolution Agreement also shows that the IRS knew how to distinguish between the individual entity and the group, in that, as distinguished from the section where it specifically listed "Nordstrom, Inc." as the entity for which the bad debt issue pertained, in areas where the agreement referred to the combined group, it listed "Nordstrom, Inc. & Subsidiaries." Thus, the IRS Audit recognized and approved the entity within the consolidated group that was claiming the bad debt deduction.

Second, the Division cites no authority or evidence to support its assertion that the IRS would not be concerned as to which entity claimed the deduction on a consolidated return. Contrary to the Division's contention, "[w]here the debt transaction is between affiliated corporations . . . all the facts must be carefully scrutinized to see whether the loss has economic realty or is the result of the shuffling of funds or assets between related entities" (***Canaveral Int'l Corp. v Commissioner***, 61 TC 520, 543-44 [1974]). The Division's mere speculation that the IRS would not care what entity claimed the deduction is thus inconsistent with the law.

Both parties cite to the ***Matter of Medtronic*** (Tax Appeals Tribunal, September 23, 1993) in support of their respective positions as to the relevance of the federal audit. The issue in that matter was whether the Division properly required the taxpayer to file franchise tax reports on a combined basis with two subsidiaries. The taxpayer argued that the fact that a federal audit resulted in no adjustments pertaining to intercompany pricing supported the conclusion that the transactions between it and the subsidiaries were arm's length and therefore combined reporting was not required. In determining whether the IRS audit was dispositive, the Tribunal stated:

> "In our opinion, establishing that as a result of an Internal Revenue Service audit either 1) an adjustment to intercorporate pricing was made (as in the USV case) or 2) the Internal Revenue Service examined intercorporate pricing and concluded that that no adjustments were necessary serves the same purpose -- it establishes the price that the Internal Revenue Service has determined to be an arm's-length price. In this case, the Federal Form 4549 was not in final form, i.e., signed by petitioner. Moreover, on its face, it does not establish that the transactions between petitioner and the subsidiaries were examined by the Internal Revenue Service. Finally, at hearing, Donald Kizershot, petitioner's Director of Taxation during the period at issue, could not recall whether the Internal Revenue Service examined petitioner's intercorporate transactions or what financial information was provided during the audit (Hearing Tr., p. 196). As a result, there is no direct evidence to establish that petitioner's transactions with its subsidiaries were examined during the course of the Internal Revenue Service audit. Accordingly, we conclude that the fact of the Internal Revenue Service audit does not prove

> that these transactions were at arm's length (Tax Law § 689[e])" (***Matter of Medtronic***).

Unlike the circumstances in ***Matter of Medtronic***, here the Issue Resolution Agreement was signed and final, and the Division has not presented any evidence or argument to the contrary. Moreover, on its face, the Issue Resolution Agreement establishes that the deduction for bad debt expense taken by Nordstrom was specifically examined and accepted by the IRS. Indeed, the Division does not dispute this, and as discussed above, stipulated that the IRS audited and accepted the deduction for bad debt expense for FYE 1/31/09 and the years at issue. Because there is direct evidence here that the IRS examined and accepted the bad debt expense deduction taken by Nordstrom, the Division's argument that the IRS audit has no bearing here is rejected (cf. ***Matter of Medtronic***; ***see also Matter of USV Pharmaceutical Corp.***, Tax Appeals Tribunal, July 16, 1992 [holding that federal audit adjustments were sufficient to meet petitioner's burden of proof to rebut the presumption of distortion and stating that: "the Division's argument that it is not 'bound' by the (federal) Closing Agreement misses the point since petitioner offers the agreement not for the purpose of binding the Division, but as proof that the adjustments made pursuant to the agreement result in a proper reflection of income for New York purposes. In short, the issue is not whether the agreement is binding, but whether the adjustments result in a proper reflection of petitioner's income"]). Here, the federal audit established that Nordstrom's deduction of bad debt expense resulted in a proper reflection of income. Accordingly, petitioner has met its burden of proving that Nordstrom was entitled to the claimed deductions for bad debt expenses for the years at issue.

I. As indicated above, petitioner has met its burden of proof regarding the bad debt deduction by virtue of the federal audit. Nevertheless, for purposes of a complete record on appeal, I will also address whether petitioner has met its burden of proof for the claimed deduction even if the federal audit was disregarded. As discussed below, petitioner has met its burden of proof to show that Nordstrom is entitled to the deduction.

To support the IRC (26 USC) § 166 deduction, a taxpayer must establish that a "bona fide" debt exists (26 CFR § 1.166-1 [c]). A bona fide debt is defined as a debt which arises from a debtor-creditor relationship (***id.***). Here, the recourse agreement entered into between NCI and Nordstrom established a bona fide debt for Nordstrom. The agreement transferred all right, title and interest in the debt to Nordstrom. Thus, Nordstrom became the creditor pursuant to the Recourse Agreement (i.e. the debtor-creditor relationship between NCI and the cardholders became a debtor-creditor relationship between Nordstrom and the cardholders).

The Division argues that Nordstrom cannot take the bad debt deduction because FSB issued the credit cards to consumers and the credit card debt was an account receivable of FSB (subsequently transferred to NCI and subsidiaries). However, a taxpayer is not required to be an original creditor of a loan for purposes of the bad debt deduction (***see Houk v Commissioner,*** 173 F.2d 821, 823-824 [5th Cir. 1949] [when an assignment of a debt is made, the assignee stands in the same position as its assignor]; ***see also Jones v. Commissioner***, 38 F2d 550 [7th Cir 1930]; ***Wedum Supply Co., Inc. v Commissioner***, 60 TCM 629 [1990] ["transfer of consumer accounts receivable from Budget Services to petitioner is not, in and of itself, an impediment to petitioner's bad debt deduction"]).

The Division further argues that petitioner has not established that a bona fide debt existed for Nordstrom because the credit card receivables were uncollectible when they were transferred to Nordstrom through the Recourse Agreement. However, contrary to the

Division's argument, "[t]he debtor-creditor relationship is no less viable because the debt was worthless when acquired" (***First Natl. Bank of Duncanville v United States***, 481 FSupp 633 [US Dis Ct, ND Texas 1979], citing ***Stamos v Commissioner,*** 22 TC 885, 888-89 [1954]; ***see also Celanese Corp. v United States***, 8 Cl. Ct. 456 [1985] [if claim was worthless at time of transfer it would not nullify taxpayer's right to deduction for worthlessness of debt]). The contractual relationship between Nordstrom and NCI transferring all right, title and interest in the debt to Nordstrom gives rise to a cognizable debt under IRC (26 USC) § 166 (***see First Natl. Bank of Duncanville v United States***). Petitioner has thus met its burden of proving that Nordstrom properly claimed the deduction for bad debt expense for the years at issue.

J. The Division argues, alternatively, that the bad debt deduction was properly disallowed because it was not an ordinary and necessary business expense under IRC (26 USC) § 162, or because it causes distortion of income.

As petitioner correctly argues, the section of the IRC that controls bad debt deductions is IRC (26 USC) § 166, not § 162. Contrary to the Division's argument that the bad debt expense was not an ordinary and necessary business expense, under IRC (26 USC) § 166 (d) (2), the term "nonbusiness debt" is defined solely for noncorporate taxpayers and in accordance with IRC (26 USC) § 166 (d) (1), all bona fide bad debts of C corporation creditors are business bad debts (***see*** Accounts Receivable Related to Business Transfers, 8 Mertens Law of Fed. Income Tax'n § 30:48; ***see also Celanese Corp. v United States*** [language of IRC former § 166 (f) that subsection applied only to a taxpayer "other than a corporation" in providing that proceeds from payment of a noncorporate taxpayer in discharge of an obligation as guarantor of a noncorporate obligation, which were used in the trade or business of the borrowers, should be treated as debt "plainly impl[ies] that all bad debt losses of a corporation are business losses and hence fully deductible either under § 165 or § 166"]).

Even if IRC (26 USC) § 162 applied, the Division provides no citations to the record for its conclusory assertion that "the bad debt deduction . . . was not ordinary or necessary for the retail store." Additionally, the Division's assertion that the "bad debt is not necessary for Nordstrom, Inc. to run its retail store," appears to improperly interpret "necessary" to mean essential or required.

An ordinary expense is one that is common and acceptable (***Welch v Helvering***, 290 US 111, 114 [1933]). A necessary expense is considered to be one that is appropriate and helpful in conducting a trade or business (***Heineman v Commissioner***, 82 TC 538, 543 [1984]). Petitioner's argument that the transfer of the debt was an ordinary expense is supported by the testimony of its vice-president of tax, Misty Heckel, who testified that the selling of credit card receivables is a very common practice. Petitioner further convincingly argues that it is appropriate and helpful for Nordstrom to take on the bad debt in order to ensure the financial soundness of Nordstrom fsb so that it continues issuing credit cards used by consumers to make purchases at Nordstrom, Inc.'s retail stores. This argument is supported by the recourse agreement which specifies the stated purpose of "ensur[ing] the Bank's safety and soundness." As further explained by Ms. Heckel, Nordstrom took on the debt in its ordinary course of business to ensure that the bank was more financially stable. Petitioner further points to its publicly available form 10-K, filed with the Securities and Exchange Commission, to support its argument that it is appropriate and helpful for Nordstrom to ensure that it remains financially attractive for Nordstrom fsb to continue issuing private label credit cards. As stated in the form

10-K, the credit card operations help drive sales in the retail stores, help the stores avoid third-party transaction fees, and strengthen customer relations and loyalty.[11]

Lastly, the Division argues that the bad debt deduction was properly disallowed because such deduction "causes a distortion of income" and cites to its discretionary authority under Tax Law § 211.5.[12] The Division's argument on the basis of distortion must be rejected because it specifically agreed in the stipulation of facts that it "did not disallow the adjustment on the basis of exercising discretion to correct a distortion" (***see*** finding of fact 80). The Division is bound by its stipulation of facts (***see Matter of Amherst Cablevision, Inc.***). To now allow the Division to raise a distortion argument, after it stipulated that the disallowance of the bad debt deduction was not based on exercising discretion to correct distortion, would be prejudicial to petitioner and is therefore rejected (***id.*** ["The stipulation is a voluntary agreement between petitioners and the Division as to the issues to be litigated in this case. It is the product of the

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[11] Official notice is taken of Nordstrom, Inc. Annual Report 2011, available at https://investor.nordstrom.com/static-files/2b4b7f2e-4afe-4839-b150-d470c5ca9e9f . Pursuant to SAPA §306 (4), official notice may be taken of all facts of which judicial notice could be taken and of other facts within the specialized knowledge of the agency. A court may take judicial notice of particular facts if the items are of common knowledge or are determinable by referring to a source of indisputable accuracy (***Matter of Piscopo***, Tax Appeals Tribunal, April 29, 2019, citing ***Matter of Crater Club v Adirondack Park Agency***, 86 AD2d 714 [3d Dept 1982], ***aff'd*** 57 NY2d 990 [1982]). Courts today will often judicially notice matters of public record (Fisch on New York Evidence, ' 1063 at 600 [2d ed]). As the annual report is a matter of public record, official notice is proper.

[12] Tax Law former § 211.5 provides "In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income, deductions and capital, and to eliminate assets in computing any allocation percentage provided only that any income directly traceable thereto be also excluded from entire net income, minimum taxable income or pre-nineteen hundred ninety minimum taxable income, so as equitably to determine the tax. Where (a) any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, or (b) any taxpayer, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, enters into any transaction with such other corporation on such terms as to create an improper loss or net income, the tax commission may include in the entire net income, minimum taxable income or pre-nineteen hundred ninety minimum taxable income of the taxpayer the fair profits which, but for such agreement, arrangement or

evaluation and acceptance by each party of the others' representations. Absent proof of fraud, malfeasance, misrepresentation of material fact or any other ground which would require this Tribunal, as a matter of justice, to permit the Division to modify the terms of the stipulation, petitioners are entitled to rely upon the representations of the Division as embodied in the stipulation."]).

K. The Division imposed penalties pursuant to Tax Law § 1085 (k), for substantial understatement of tax. Tax Law § 1085 (k) provides that if there is a substantial understatement of tax, an amount equal to ten percent of the amount of any underpayment attributable to such understatement will be added to the tax. For purposes of subsection (k) there is a substantial understatement of tax if the amount of the understatement exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year or $5,000.00 (***see*** Tax Law § 1085 [k]). Tax Law § 1085 (k) further provides that all or any part of the addition to tax may be waived on a showing by petitioner that there was reasonable cause for the understatement and that it acted in good faith. First, with respect to the § 311 (b) issue, the Division's answer affirmatively states the "NIHC 311 (b) issue was not an issue that generated the additional tax assessed on the subject Notice of Deficiency, and, as such, is not an issue related to the assessment of the § 1085 (k) penalties."

With respect to petitioner's argument that reasonable cause exists justifying penalty abatement for the penalties resulting from the Division's disallowance of the bad debt deduction in each of the years at issue, this argument has been rendered moot based upon the conclusions reached above. Nonetheless, such argument is addressed for sake of a complete record (***see Matter of Riehm v Tax Appeals Trib.***, 179 AD2d 970 [3d Dept 1992], ***lv denied*** 79 NY2d 759

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understanding, the taxpayer might have derived from such transaction."

[1992], ***reargument denied*** 80 NY2d 893 [1992]). Based on a review of the record, it is determined that petitioner has met its burden of proof to show that there was reasonable cause for the understatement and that it acted in good faith.

Petitioner had reasonable cause and acted in good faith in claiming the deduction for bad debt expense for Nordstrom, as such amounts were the same as reported to the IRS in computing federal taxable income and were accepted by the IRS. The Division stipulated that on its federal corporate income tax returns for each year at issue (filed on a consolidated basis), Nordstrom took a deduction for bad debt expense and that the IRS audited the bad debt expenses on those returns and did not make any adjustment to them. The Issue Resolution Agreement shows that the IRS reviewed and accepted the deduction for bad debt taken by Nordstrom for FYE 1/31/09, the year immediately preceding the years at issue. Nordstrom thus reasonably used its federal taxable income accepted by the IRS as its starting point in computing entire net income. Additionally, petitioner acted in good faith, as the bad debt deduction was not disallowed by the Division during the prior audits, and the closing agreement for the Third NY Audit specifically references the deduction and states that no adjustment will be made. While the closing agreements for prior years are not binding on future years, petitioner acted reasonably as the same deductions claimed for Nordstrom were allowed in those prior years and NCI/FSB were not required to be included in the combined group for those years.

L. The petition of Nordstrom, Inc. and Combined Affiliates is granted to the extent indicated in conclusions of law G, H, I, J, and K, but is otherwise denied, and the Division is directed to modify the notice of deficiency dated July 12, 2018 consistent with this determination.

DATED: Albany, New York
July 07, 2022

/s/ Barbara J. Russo
ADMINISTRATIVE LAW JUDGE