New York – ALJ upholds decombination based on failure to show substantial intercorporate transactions

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In brief

In a case of first impression under New York's post-2006 combined reporting provisions, the decombination of two affiliated companies by the Division of Taxation was upheld by an administrative law judge where the companies failed to demonstrate the existence of substantial intercorporate transactions. The ALJ declined to consider arguments that combined filing should be allowed to avoid distortion. This case highlights the Division's continued audit focus on combination and decombination, including situations where filing on a combined basis benefits taxpayers. [*In the Matter of the Petitions of Knowledge Learning Corporation and Kindercare Learning Centers, Inc*., NY Division of Tax Appeals, Nos. 823962 and 823963, 6/27/13]

In detail

Facts

Knowledge Learning Corporation (KLC) and Kindercare Learning Centers (Kindercare) were separate companies that operated a variety of child care centers within the State of New York. In January 2005, KLC purchased Kindercare. For the 2005 and 2006 tax years, the companies filed separate New York franchise tax returns. However, for the 2007 tax year, the entities filed a combined return, which included other affiliates. The combined filing enabled KLC's $57.6 million loss to partially offset Kindercare's $109.3 million of income.

Audit and appeal

In 2009, the New York Division of Taxation (Division) conducted an audit, the result of which was a finding that since the KLC and Kindercare (Taxpayers) did not provide adequate evidence to support substantial intercorporate transactions, their income and expenses were properly reflected on a separate basis. A notice of deficiency was then issued, which both companies contested.

Law and guidance

An administrative law judge (ALJ) of the Division of Tax Appeals, explained that prior to 2007, state law granted the Division discretion to require or permit corporations to file on a combined basis. The law required that a taxpayer either own or control substantially all of the stock of the other corporations, or the taxpayer's stock be substantially owned or controlled by such other corporations.

Statutory amendments effective for the 2007 tax year require corporations that satisfy certain common ownership or control requirements to file a combined franchise tax report where there are *substantial intercorporate transactions,* regardless of the transfer price for such transactions. In determining whether substantial intercorporate transactions exist, all activities and transactions of the taxpayer and its related corporations must be examined, including, but not limited to: (1) manufacturing, acquiring goods or property, or performing services for related corporations; (2) selling goods acquired from related corporations; (3) financing sales of related corporations; (4) performing related customer services using common facilities and employees; (5) incurring expenses that benefit, directly or indirectly, one or more related corporations; and (6) transferring assets, including such assets as accounts receivable, patents, or trademarks from one or more related corporations.

Guidance issued by the Division in 2008 (TSB-M-08(2)C) provides that the substantial intercorporate transaction requirement will be satisfied if during the taxable year 50% or more of a corporation's receipts or expenditures (including expenditures for inventory) are from one or more related corporations. A transfer of assets to a related corporation (including through incorporation) will satisfy the substantial intercorporate transactions requirement where 20% or more of the transferee's gross income (as defined under IRC Section 61(a)), including any dividends received, is derived directly from the transferred assets and the corporations engage in a unitary business.

Failure to show substantial intercorporate transactions

The taxpayers advanced two primary arguments supporting that substantial intercorporate transactions existed: (1) all employees of the affiliate group were KLC employees and (2) KLC paid all of the expenses of Kindercare. The Division rejected both arguments, and also provided that the transactions had no economic substance.

Absence of written agreements for intercompany services

Taxpayers asserted that all affiliated group employees were transferred to KLC on January 1, 2006. One employee testified that her paychecks and W-2s were issued by KLC. The ALJ found that the only documented support for the transfer was an internal memo that referenced employees as part of the 'KLC team' and outlined certain anticipated employee benefits. However, there were no employee contracts, no agreements memorializing intercompany services (but for a master intercompany lease), and no income reported by KLC for leasing employees. Additionally, Kindercare reported payroll on its 2006 New York franchise tax return.

Accordingly, the ALJ found that the absence of written agreements memorializing employee transfers weighted heavily against the taxpayers.

Accounting entries did not support substantial incorporate transactions

Taxpayers asserted that their intercompany transaction journal entries reflected that KLC paid Kindercare's expenses. These entries provide that every time a cash transaction was posted for Kindercare, an intercompany journal entry was recorded. The ALJ determined that this flow of cash resulted in KLC paying expenses on behalf of Kindercare using Kindercare's own cash to do so. Additionally, Kindercare deducted these expenses on its tax returns. Accordingly, the ALJ found that the journal entries were "nothing more than accounting entries and, as such, are not considered transactions for purposes of the substantial intercorporate transactions" requirement.

No economic substance of the transactions

In determining whether substantial intercorporate transactions exist, the TSB provides that the Division will consider "the materiality of the transactions and whether the transactions have economic substance." The ALJ observed the duties, obligations, and daily activities of the affiliated employees did not change following their purported January 1, 2006 transfer to KLC. Without much analysis, the ALJ concluded that the taxpayers failed to show that substantial intercorporate transaction existed.

Distortion dismissed

It should be noted that the taxpayers also argued, as an alternative, that they were 'entitled' to file a combined report in order to avoid distortion under the prior statutory framework. The ALJ stated that "[s]ince it has been determined that distortion is not the proper analysis in light of the 2007 statutory amendment, such argument need not be addressed…"

MCTD surcharge

The ALJ also addressed an adjustment to KLC's Metropolitan Commuter Transportation District (MCTD) surcharge property factor. The MCTD's apportionment property factor is based on the value of actual property, owned and leased, within and without the district. During the audit, the taxpayers provided such values to the Division, but were unable to substantiate such values. As a result, the Division used an alternative apportionment based on the number of locations that the taxpayers had in the district to total number of sites within the state.

The ALJ found in favor of the Division's approach, stating that, given that the taxpayers did not substantiate the values provided to the Division, there was no demonstration that the Division's ratio was inappropriate.

The takeaway

This case provides clear evidence that the Division will actively seek to decombine taxpayers, especially where combination yields a tax benefit. Given the lack of documented intercompany transactions in this instance, it is not particularly surprising that the decombination was upheld.

However, the ALJ's dismissal of the distortion argument is potentially troubling. A reader of the decision might get the impression that combination is entirely dependent upon the existence of substantial intercorporate transactions. However, the law and the TSB provide that combined filing might still be required upon the existence of inter-company transactions or some agreement, understanding, arrangement or transaction in order properly to reflect tax liability.

Click here for our summary of the 2012 combined reporting regulation amendments, which substantially follow the guidance provided in the TSB.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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