

# *New York ALJ - Corporations properly filed combined returns, defeated department attempt to force separate filing*

January 11, 2013

## ***In brief***

An ALJ held that three related corporations properly filed combined New York franchise tax returns for the 2002 to 2004 tax years because they satisfied the capital stock, unitary business, and distortion requirements for combined filing in place during those tax years. In so ruling, the corporations were able to defeat an attempt by the Department of Taxation and Finance on audit to decombine the entities. [[\*In re IT USA, Inc. and Manifatture Associate Cashmere USA, Inc.\*](#),<sup>i</sup> Division of Tax Appeals, Determination DTA Nos. 823780 and 823781 (12/20/12)]

## ***In detail***

### ***Facts and procedural history***

IT Holding USA, Inc. (IT Holding) was formed in 2001 to centralize all United States management and administrative functions of IT Holding SpA, an Italian clothing company based in Milan, Italy. IT Holding performed various services for its wholly-owned subsidiaries, IT USA, Inc. (IT USA) and Manifatture Associate Cashmere USA, Inc. (MAC), receiving no reimbursement for such services.

One individual was the president of IT Holding, IT USA, and MAC, and his responsibilities included

overseeing all aspects of IT Holding's departments and controlling exclusively the operations of IT USA and MAC, including making all sales decisions. IT Holding, IT USA, and MAC each had their own checking accounts; however, these accounts were linked online and the president would freely transfer cash between the accounts at his discretion.

For the 2002 to 2004 tax years, IT Holding, IT USA, and MAC (the "Corporations") filed as members of a combined group for New York franchise tax purposes. Following an audit of the combined reports, the Department determined that the Corporations should have been

filing on a separate basis and assessed the Corporations as if they had filed separate entity returns. The Corporations appealed the assessment to the Division of Tax Appeals.

### ***Combined filings***

For tax years 2002 to 2004, taxpayers could file (or be required to file) combined corporation franchise tax reports upon satisfying the capital stock requirement, the unitary business requirement, and the "other" or "distortion" requirement, as summarized below. A Division of Tax Appeals Administrative law Judge (ALJ) found that the

Corporations satisfied each of the three requirements and concluded that they properly filed their corporation franchise tax reports on a combined basis.

### **Capital stock requirement**

In general, the capital stock requirement is satisfied when certain direct or indirect ownership or control requirements are satisfied. The capital stock requirement was not at issue in this case because IT USA and MAC were wholly-owned subsidiaries of IT Holding.

### **Unitary business requirement**

Under New York regulations, the following were considered in determining whether a corporation is part of a unitary business: (1) whether the activities in which the corporation engages are related to the activities of the other corporations in the group; and (2) whether the corporation is engaged in the same or related lines of business. The ALJ found that the related activities of the Corporations "clearly satisfy" unitary business requirements under New York regulations because:

- IT Holding did not sell any products of its own, but merely provided services to IT USA and MAC.
- The Corporations were all engaged in the same or related lines of business. IT USA and MAC sold Italian clothing and apparel and IT Holding managed an Italian clothing and apparel business and serviced corporations selling Italian clothing and apparel.

The ALJ noted that, under federal constitutional standards, the key to a unitary business finding is the existence of a "flow of value" from one corporation to another. The ALJ found that a "flow of value" existed in

numerous areas among the Corporations, such as:

- IT Holding performing day-to-day functions for the subsidiaries, including being responsible for hiring and firing the subsidiaries' employees, renting a warehouse where the subsidiaries stored merchandise, and organizing and financing fashion shows for the subsidiaries;
- IT Holding not being reimbursed for costs incurred on behalf of the subsidiaries;
- the cash management system, which transferred funds between the Corporations, allowed MAC to receive money to stay solvent without repayment; and
- one individual exercising control over all of the Corporations, including transferring cash between the Corporations at his discretion.

### **Distortion requirement**

The ALJ noted that the unitary business test and the distortion of income test were interrelated factors. The issue was whether, under all of the circumstances of the intercompany relationship, combined reporting fulfilled the statutory purpose of avoiding distortion of and more realistically portraying true income.

Under New York regulations, there were two ways distortion could be demonstrated:

- A presumption of distortion existed if "there are substantial intercorporate transactions among the corporations;" or
- if the filing of a report on a separate basis resulted in a "distortion of such taxpayer's

activities, business, income, or capital."

Because there was no claim of substantial intercorporate transactions in the instant case, the Corporations bore the burden of proving distortion. The ALJ concluded that the Corporations established distortion because they did not conduct their unitary business on arm's length terms, noting the Corporations' cash management system and unreimbursed loans, services, and use of property.

### **The takeaway**

Effective for tax years beginning on or after January 1, 2007, New York changed the circumstances under which a taxpayer is required or permitted to file a combined report, focused primarily on whether substantial intercorporate transactions exist between taxpayers. While this decision involves pre-2007 tax years, its analysis remains relevant for taxpayers where decombination may be an issue for tax years open before 2007. Although cases determining unity are very fact-specific, the arguments presented by the taxpayer may prove useful to others currently facing decombination audits by the Department.

While combined return rules for 2007 and later tax years focus on a measure of substantial intercorporate transaction, combined filing may still be permitted or required on a finding of a unitary business not being conducted at arm's length. Accordingly, the unitary and distortion discussions in this case remain instructive even after the 2007 combination change.

If remains uncertain whether the Department will appeal this decision to the Tax Appeals Tribunal. Unlike

ALJ decisions, Tribunal decisions create precedent and the Department

may not want a successful decombination challenge published.

## **Let's talk**

If you have any questions about the *IT USA* decision, please contact one of the following individuals:

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<sup>i</sup> The New York State Division of Tax Appeals website, [www.nysdta.org](http://www.nysdta.org), was experiencing issues at the time of publication, which may adversely impact the ability to obtain the decision from the above link.