

New York – Combination granted, intercompany charges reimbursed at cost creates distortion

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In brief

The New York Tax Appeals Tribunal rejected an attempt by the Division of Taxation to decombine a holding company and its subsidiaries for their 2002 – 2004 tax years, concluding that since the holding company was reimbursed for services provided to the subsidiaries at cost only, with no markup, separate filing would yield a distortive result. In upholding the decision of an administrative law judge, the tribunal also concluded that capital stock and unitary requirements for combination were also met. [[In the Matter of the Petition of IT USA, Inc. and Manifatture Associate Cashmere USA, Inc.](#), Tax Appeals Tribunal, Decision DTA Nos. 823780 and 823781 (4/16/14)]

The Division of Taxation is precluded from appealing determinations from the Tax Appeals Tribunal. Thus, the issue is final as to these taxpayers. Although the taxpayer won this appeal, and the decision can be referred to by taxpayers fighting forced decombination, the Division might look at the decision as a tool to force combination where the circumstances are similar. While this is a state decision, this may also be cited as precedent on similar New York City matters.

In detail

The facts

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). There was no written management services agreement between IT Holding and the subsidiaries.

Consolidated financial statements showed that the management fees earned by IT Holding were based on IT Holding's cost of its operations, with no markup. The fees were allocated among the subsidiaries based on estimates of the number of hours IT Holding employees committed to each subsidiary. The intent was that IT Holding be reimbursed for its costs without recognizing a gain or loss.

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 Division 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, which rejected the Division's determination to decombine the entities. [Click here](#) for a summary of the ALJ's decision.

The Division appealed to the New York Tax Appeals Tribunal.

Combination requirements

During the tax years at issue, New York was a separate filing state. However, combined reports were required or permitted when the corporations in a group satisfied a capital stock requirement, a unitary business requirement, and the 'other' or 'distortion' requirement. There was no dispute regarding the capital stock requirement, as the subsidiaries were wholly-owned. The tribunal also agreed with the ALJ that the unitary business requirement was met, noting that the Corporations were all engaged in the same line of business and that IT Holding's primary business activity was providing services to its subsidiaries, which were essential to the subsidiaries' business activities. The tribunal, noting the Corporations' common president, centralized management, administrative support system, and common cash management system, concluded that the requisite flow of value among the entities existed to support federal constitutional requirements for a unitary business.

Distortion

The tribunal then addressed the distortion requirement. Distortion

exists where filing on a separate basis results in a distortion of a taxpayer's activities, business, income, or capital. The party seeking combination bears the burden of proving distortion. The ALJ found that IT Holding's provision of management, corporate, administrative, and logistical services to its subsidiaries at cost resulted in distortion. The tribunal noted its previous decision where it found that the lack of markup on transactions between a parent and subsidiary resulted in distortion. The tribunal said "controlled transactions must be on arm's length terms to avoid distortion and that arm's length normally means markup over cost." Accordingly, the tribunal, agreeing with the ALJ, found that the Division improperly recomputed the taxpayers' liability based on separate filings.

The takeaway

The Division of Taxation is precluded from appealing determinations from the Tax Appeals Tribunal. Thus, the issue is final as to these taxpayers. Although the taxpayer won this appeal, and the decision can be referred to by taxpayers fighting forced decombination, the Division might look at the decision for authority to force combination where the circumstances are similar.

It should be noted that this case was decided under New York's pre-2007 filing regime, with distortion being a key feature in determining whether combination is required. After that, and through tax year 2014, combination is required only upon the satisfaction of certain common ownership or control requirements and the existence of substantial intercorporate transactions, regardless of the transfer price for such transactions. However, starting in 2015, combined reports must be filed by any taxpayer that meets certain 50% ownership thresholds of other corporations *and* that is engaged in a unitary business with those corporations. Thus, unity is set to reemerge as a key issue in determining the necessity of combination.

In this case, the tribunal noted that the concepts of distortion and unity are related and that the same factors that indicate a unitary business may also give rise to distortion. Accordingly, the issues addressed in distortion disputes are still relevant, not only to taxpayers involved in disputes under the pre-2007 filing regime, but in determining whether unity exists.

Let's talk

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

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