**New York Tax Tribunal – Taxpayers may file combined returns to avoid distortion even in the absence of substantial intercorporate transactions**

**September 30, 2014**

**In brief**

In a case of first impression under New York’s post-2006 combined reporting provisions, the New York Tax Appeals Tribunal found that combined returns may be filed in the absence of substantial intercorporate transactions when necessary to properly reflect income and avoid distortion.

The Tribunal also found that substantial intercorporate transactions existed among the taxpayers following the transfer of employees from one entity to another. The Tribunal recognized that the transfer had a business purpose and economic substance and therefore transactions relating to the transfer could be considered for purposes of satisfying the substantial intercorporate transactions test.

New York revised its combined reporting rules for tax years beginning on or after January 1, 2015, abandoning its substantial intercorporate transactions rule for a unitary reporting method. Accordingly, this decision remains relevant for the 2007 to 2014 tax years. The decision may also remain relevant for New York City purposes after 2014 depending on whether the City conforms to New York State’s combined reporting regime effective January 1, 2015. [In the Matter of the Petitions of Knowledge Learning Corporation and Kindercare Learning Centers, Inc., NY Division of Tax Appeals, Nos. 823962 and 823963 (9/18/14)]

**In detail**

**Facts**

For the 2007 tax year, Knowledge Learning Corporation (KLC) and Kindercare Learning Centers (Kindercare) 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**

Pursuant to an audit, the New York Division of Taxation (Division) found that, for the 2007 tax year, the income and expenses of KLC and Kindercare (Taxpayers)
should be reported on a separate basis because there was inadequate evidence to support substantial intercorporate transactions between them.

On appeal, 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. An Administrative Law Judge (ALJ) at the Division of Tax Appeals found that Taxpayers failed to establish that substantial intercorporate transactions existed during the 2007 tax year. Specifically, the ALJ found that: (1) there was insufficient evidence to show that subsidiary employees were transferred to KLC and (2) the employee transfers lacked a valid business purpose and economic substance because the duties, obligations, and daily activities of the employees did not change following the transfer.

Additionally, the ALJ dismissed Taxpayer’s alternative argument that combined filing was necessary to avoid distortion. The ALJ reasoned that distortion is no longer the proper analysis in determining whether combined filing should be permitted or required.

Taxpayers appealed the Division’s findings to the Tax Appeals Tribunal.

**Law and guidance**

Effective for tax years commencing on or after January 1, 2007, New York required corporations that satisfy certain common ownership or control requirements to file a combined franchise tax report when substantial intercorporate transactions exist, 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.

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 percent or more of a corporation’s receipts or expenditures (including expenditures for inventory) are from one or more related corporations.

**Distortion may support combined reporting in absence of substantial intercorporate transactions**

For taxable years commencing prior to 2007, the Division had the discretion to permit or require combined filing when substantial ownership, unitary business, and distortion tests were satisfied. Under this former regime, distortion was presumed when ‘substantial intercorporate transactions’ were present. New York regulations at the time provided that in the absence of substantial intercorporate transactions, combined filing was required when “the filing of a report on a separate basis . . . results in a distortion of such taxpayer’s activities, business, income or capital.”

Effective starting in the 2007 tax year, New York law provides for combined returns in the absence of substantial intercorporate transactions when the commissioner deems such a return necessary “in order to properly reflect” New York tax liability. The Tribunal recognized that such language is identical to pre-2007 language and that (presumably based on the pre-2007 interpretative regulation) such language has been consistently interpreted to mean that “combined filing is required to avoid distortion and to properly reflect income.”

As a result, the Tribunal found that the ALJ erroneously concluded that distortion is no longer a factor for determining combined filing for the 2007 tax year. The Tribunal concluded that, for the 2007 tax year, New York allows combined returns to be filed, “even in the absence of substantial intercorporate transactions, when combined filing is necessary to properly reflect income and avoid distortion.”

Because the Tribunal found that substantial intercorporate transactions existed in this case, the Tribunal did not reach the issue regarding whether distortion was present.

**Substantial intercorporate test satisfied**

Taxpayers asserted that substantial intercorporate transactions existed and that Kindercare’s payment to KLC for the use of its employees constituted the bulk of such transactions. KLC’s employees were former employees of Kindercare who were transferred to KLC on January 1, 2006. To reach its determination that substantial intercorporate transactions existed, the Tribunal concluded that: (1) employees of Kindercare were transferred to KLC and (2) such transfer had a valid business purpose and economic substance. Additionally, the Tribunal concluded that other expenses paid by KLC on behalf of Kindercare out of a cash management system were valid intercompany expenses.

Kindercare’s intercorporate expenses with KLC, which included the transferred employees and other expenses, amounted to more than 50% of its total expenditures. Accordingly, Kindercare and KLC satisfied the substantial intercorporate transactions test for combined filing for the 2007 tax year.
**Employees were transferred**

The Division looked to Taxpayers’ separately filed 2006 New York returns as support that employees were not transferred to KLC. Kindercare’s 2006 return reported $386 million of everywhere payroll and KLC’s 2006 return did not report income from leasing employees to Kindercare. Additionally, there were no written intercompany service agreements provided by Taxpayers.

Nevertheless, the Tribunal considered the entirety of the record and found that the employees were in fact transferred to KLC due to: (1) a consulting letter evidencing KLC’s intent to transfer all of Kindercare’s employees to its payroll on January 1, 2006, (2) KLC’s 2005 and 2006 federal unemployment tax returns reflecting an increase in payroll and number of employees for KLC in 2006, and (3) other documentation and witness testimony demonstrating KLC’s business strategy of operating as a single company.

**The employee transfers were made with a valid business purpose and economic substance**

The Division asserted that the employee transfers lacked economic substance because the duties, obligations, and daily activities of the employees did not change following the transfer.

The Tribunal disagreed with the Division’s analysis and provided that the issue of economic substance depends on whether a common law employer-employee relationship existed between KLC and the transferred employees. The requirements for such a relationship include: (1) authority to hire and fire, (2) authority to control and direct the work of the employee, and (3) payment of wages. Because the Tribunal found the record supported that KLC satisfied these requirements, the transfer of employees had economic substance.

Additionally, the Tribunal found that the employee transfer had business purpose and was not tax-motivated because it was part of a reasonable business strategy of operating Taxpayers as a single company, as evidenced by: the consolidation of employees into one payroll, centralized cash management, centralized risk management, and centralized purchasing.

**Allocation of costs for third party purchases in a central cash management system**

The Division asserted and the ALJ agreed that KLC’s payment of Kindercare expenses did not constitute intercorporate transactions because Taxpayers’ cash management system amounted to KLC paying Kindercare’s expenses with Kindercare’s cash. The cash management system operated by posting Kindercare’s receipts through intercompany accounts and concentrating cash at KLC. All payments of Kindercare’s expenses were made by KLC.

The Tribunal disagreed, finding that payments made by Kindercare to KLC for janitorial service, transportation services, food, and supplies were intercorporate transactions because KLC made such purchases from third party providers and allocated the costs to the appropriate Taxpayer location.

**The takeaway**

Because the state cannot appeal a Tribunal decision, there should be no subsequent court review of this matter.

This decision makes it clear that, following the 2007 law change, distortion remains a factor in determining combined group members. It also supports the position that when one company incurs an expense and charges it out to a related corporation, the charge should be considered for the substantial intercorporate transaction test.

As with the Tribunal’s decision in *IT USA* (click here for our summary), in which a taxpayer defeated the Division’s attempt to force decombination, this represents a major win for the taxpayer and it should lead to a greater willingness on the part of the Division to resolve combination cases at the audit level.

The decision also highlights the importance of taxpayers maintaining contemporaneous documentation to reflect the intent of their actions. In this case, Taxpayers offered consulting advice written in July 2005 detailing the January 2006 employee transfer. The Tribunal found that such documentation provided "objective, contemporaneous evidence” of the intent to transfer all employees to KLC. The documentation also served to corroborate witness testimony to support Taxpayers’ claim that the employees were transferred to KLC.
Another subsidiary, Mulberry Child Care Centers, Inc. was analyzed in a fashion similar to Kindercare. For purposes of this Insight, only Kindercare is addressed.

Let’s talk
If you have any questions regarding the Knowledge Learning Corporation decision, please contact:

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