New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-89 (2)C
Corporation Tax
January 31, 1989

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C880726A

On July 26, 1988, a Petition for Advisory Opinion was received from United States Surgical Corporation, 150 Glover Avenue, Norwalk, Connecticut 06856.

The issue raised is whether for taxable years 1984, 1985 and 1986, Petitioner is required to file a combined franchise tax report with its wholly owned subsidiary, to properly reflect Petitioner's franchise tax liability under Article 9-A.

Facts

Petitioner's subsidiary, Auto Suture FSC Ltd. (hereinafter "FSC") was incorporated in the U.S. Virgin Islands on December 21, 1984. It filed an election to be taxed as a foreign sales corporation for federal income tax purposes on March 20, 1985.

FSC has no property, payroll, or sales in New York State. Its income is derived from commissions earned on its participation in export sales made by its related supplier, Petitioner. Its expenses relate to the performance through its agents of substantive activities ("foreign economic processes") relating to such export sales. All these activities take place offshore.

Pursuant to the requirements of section 922 of the Internal Revenue Code (hereinafter "IRC"), and the regulations thereunder, FSC maintains an office in the Virgin Islands. This office is administered by an unrelated management company to whom an annual fee is paid by FSC. As required by the IRC, various records of FSC are maintained at this office. These records include invoices, statements of accounts, quarterly income statements, and annual balance sheets. The Board of Directors of FSC consists of three individuals. Two of the directors are officers of Petitioner. A third director is an outside director who resides in the U.S. Virgin Islands. All board meetings are held in the U.S. Virgin Islands pursuant to the foreign management requirements of section 924 of the IRC.

In accordance with the rules prescribed by section 924 of the IRC, FSC performs various activities relating to the solicitation of export sales as well as specified economic processes relating to export sales. Since FSC has no employees, these activities are performed by others on behalf of FSC. Accordingly, FSC has entered into a number of contracts that provide for the performance of these activities.

The basic contract entered into between FSC and Petitioner provides for the participation of FSC in transactions that give rise to "foreign trading gross receipts." The contract further provides that various services may be provided for FSC in connection with such participation, either by Petitioner or by third parties. The contract provides for payment to Petitioner for services rendered by it.

Another contract entered into by FSC with Auto Suture U.K. Ltd. (hereinafter "U.K."), a wholly owned subsidiary of Petitioner, provides for the performance of certain services by U.K. relating to the export sales in which FSC participates. These services include the preparation of invoices and statements of account. The agreement provides for the payment of fees by FSC to U.K.

FSC's income is earned in the form of commissions paid to it by Petitioner. The commissions are based on export sales made by Petitioner. These sales include both sales to wholly owned foreign subsidiaries and sales to unrelated foreign customers. The commissions are determined pursuant to the administrative pricing rules prescribed by section 925 of the IRC. These rules permit FSC to earn a "safe harbor" profit and provide that the Internal Revenue Service may not make any further allocations of income under section 482 of the IRC.

New York State has not enacted any special provisions concerning the taxability of foreign sales corporations. Petitioner contends that inasmuch as New York State generally accepts federal income tax concepts, including those relating to allocation of income pursuant to section 482 of the IRC, and inasmuch as FSC has properly availed itself of the administrative pricing rules provided by section 925 of the IRC, a combined report would not be necessary in order to properly reflect Petitioner's franchise tax liability. Petitioner also contends that the failure of the Legislature to enact any specific provision relating to a foreign sales corporation evidences its intent that the administrative pricing rules would be deemed to properly reflect Petitioner's tax liability.

Discussion

The foreign sales corporation provisions contained in sections 921 through 927 of the IRC were added by P.L. 98-369 and are applicable to transactions after 1984 in tax years ending after December 31, 1984.

Section 925 of the IRC provides that in the case of a sale of export property to a foreign sales corporation by a related person, the taxable income of both the foreign sales corporation and the related person is based upon a transfer price determined under an arm's-length approach.

Treasury Regulation section 1.925(a)-lT provides the transfer pricing rules. Such rules apply, generally, only if a transaction gives rise to foreign trading gross receipts. However, such rules will also apply if the foreign sales corporation is acting as commission agent for a related supplier with regard to a transaction on which the related supplier is the principal, if the transaction would have resulted in foreign trading gross receipts had the foreign sales corporation been the principal. The allowable transfer price or commission a related party may charge or pay to a foreign sales corporation is determined by one of three transfer pricing methods: the "1.83 percent" gross receipts method and the "23 percent" combined taxable income method (these are described as the administrative pricing rules and they may be used when certain conditions are met) and the section 482 method. Subject to the special no-loss rule, any or all of the transfer pricing methods may be used in the same taxable year for separate transactions or groups of transactions. If either of the

administrative pricing rules is applied to a transaction, the Commissioner of the Internal Revenue Service may not make distributions, apportionments or allocations as provided by section 482 of the IRC.

The transfer pricing rules only apply to the price of a sale to a foreign sales corporation (or foreign sales corporation commissions). A foreign sales corporation, or a principal for which the foreign sales corporation is acting as commission agent, must sell to a related purchaser on an arms-length basis, under the provisions of section 482 (relating to the allocation of income and deductions between related parties), viewing the foreign sales corporation and any related supplier as a single entity which sells to the purchaser. S.Prt. No. 169, 98th ConE., 2d. Sess., Vol. 1, 649 (1984).

Section 211.4 of the Tax Law authorizes the Commissioner of Taxation and Finance (hereinafter "Commissioner"), in his discretion, to require or permit a parent corporation and its wholly-owned subsidiaries to file a franchise tax report on a combined basis. However, a combined report embracing a corporation not a taxpayer (i.e., a foreign corporation not doing business in New York) cannot be required unless the Commissioner deems such a report necessary, in order to properly reflect the tax liability under Article 9-A because there are intercompany transactions or some agreement, understanding, arrangement or transaction referred to in section 211.5.

Section 6-2.1 of the Business Corporation Franchise Tax Regulations (hereinafter "Regulations") provides that the capital stock requirement, the unitary business requirement and the other requirement set forth in section 6-2.3 or section 6-2.5(a), as the case may be, must be met before the Commissioner may require a group of corporations to file on a combined basis. Herein, it is clear that the capital stock and the unitary business requirement have been met. Thus, question is whether the requirement of section 6-2.5 has been met.

Section 6-2.5 of the regulations provides that a foreign corporation not subject to tax in New York will not be required to be included in a combined report unless the Commissioner determines that inclusion of the corporation is necessary to properly reflect the tax liability of one or more taxpayers included in the group either because of substantial intercorporate transactions or because of some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected.

Herein, FSC operates in accordance with the extensive rules prescribed by section 924 of the IRC. When certain conditions are met, the commissions earned by FSO may be determined pursuant to the administrative pricing rules prescribed by section 925 of the IRC. Where the administrative pricing rules are not used, the provisions of section 482 of the IRC are applied. Transfer pricing rules apply to individual transactions or groups of transactions. Accordingly, in a taxable year the administrative pricing rules could be applied to some transactions, while section 482 rules are applied to other transactions. If the administrative pricing rules are applied to a transaction, the Commissioner of the Internal Revenue Service may not make distributions, apportionments or allocations as provided by section 482 of the IRC. However, the administrative pricing rules only apply to the commissions earned by FSC on the sale of export property. The administrative pricing rules do not apply to the amount Petitioner charges FSC for the services it performs for FSC. In addition, section 482 rules will apply to the sales price charged to a related purchaser, viewing

Petitioner and FSC as a single entity selling to the purchaser.

In Standard Manufacturing Co. Inc., v. State Tax Commission, 114 AD2d 138, aff'm 69 NY2d635, the court found sufficient evidence to support the determination that a combined report should be filed notwithstanding the taxpayer's assertions that it had shown that distortion was impossible since the taxpayer had entered into an agreement with the Internal Revenue Service to adjust taxpayer's prices to reflect arm's-length transactions under section 482 of the IRC. The court found such assertions flawed in light of the absence of proof that price adjustments pursuant to the agreement were made for the years at issue.

It appears that Petitioner's contention that a combined report would not be necessary inasmuch as FSC has properly availed itself of the administrative pricing rules provided by section 925 of the IRC is equally flawed in the absence of proof that price adjustments were made for the years at issue.

Moreover, in the Matter of Digital Equipment Corporation, Decision of the State Tax Commission, June 28, 1985, TSB-H-85(29)C, the Tax Commission determined that a combined report was not required and it indicated that:

> Unlike Matter of Standard Manufacturing Co., Inc. (State Tax Comm., May 2, 1984), where the taxpayer unsuccessfully asserted that section 482 adjustments assured arm's length prices between it and its Puerto-Rican- based subsidiary for subsequent years not reviewed by the Service, Digital provided evidence of changes for the taxable years at issue. The Audit Division then made no showing that such changes did not result in arm's length prices. (Emphasis supplied).

It must be concluded from the last sentence of the above quotation that a combined report would be appropriate even in a case where section 482 adjustment are made by the Internal Revenue Service if non-arm's length prices (and hence distortion) are found to exist. (See also, Matter of Boehringer Ingelheim Pharmaceuticals, Inc., Decision of the State Tax Commission, January 17, 1986, TSB-H-86(5)C).

Additionally, franchise tax regulation section 6-2.5(a) provides that a foreign corporation will not be required to be included in a combined report unless inclusion is necessary to properly reflect the tax liability of a taxpayer because of substantial intercorporate transactions or some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of the taxpayer is improperly or inaccurately reflected. Thus, based upon regulation section 6-2.5(a), a foreign corporation may be required to be included in a combined report if it is necessary to properly reflect the tax liability of a taxpayer if substantial intercorporate transactions exist whether or not some agreement, understanding, arrangement or transaction results in a taxpayer's activity, business, income or capital being inaccurately or improperly reflected.

Accordingly, for the taxable years at issue, it is determined that the Commissioner is not precluded from requiring the inclusion of FSC in a combined report of Petitioner under the circumstances described herein if the Commissioner determines that inclusion is necessary to properly reflect the tax liability of Petitioner. In addition, it is noted that the foreign sales corporation provisions contained in sections 921 through 927 of the IRC were applicable to

transaction after 1984 in tax years ending after December 31, 1984.

Whether the inclusion of a corporation in a combined report is necessary is a question of fact not susceptible of determination in an Advisory Opinion. An Advisory Opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to "a specified set of facts". Tax Law, § 171, subd. twenty-fourth; 20 NYCRR 901.1(a). Therefore, a determination cannot be made in an Advisory Opinion as to whether a combined report shall be permitted or required. Inasmuch as the question of whether Petitioner and FSC will be required to file a combined report for taxable years ending 1984, 1985 and 1986, arises within the context of an audit, the necessary factual determination will be made within such context, in accordance with the principles outlined above.

DATED: January 31, 1989

s/FRANK J. PUCCIA
Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.