NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition	:	**DETERMINATION**
of	:	**TAT(H)14-15(GC)**
HMC-New York Inc.	:	

Bunning, A.L.J.:

The Petition in this case, dated July 9, 2014, was filed with the Administrative Law Judge Division of the New York City (City) Tax Appeals Tribunal (Tribunal). It protests a Notice of Determination dated May 13, 2014 seeking to impose City general corporation tax (GCT) under Chapter 6 of Title 11 of the City Administrative Code (Administrative Code) on the Petitioner for the period January 1, 2008 to December 31, 2010 (the Tax Years), in the amount of $4,480,525.54, and interest computed to June 30, 2014 of $2,202,692.06, for a total of $6,683,217.60.

On June 13, 14, 15, and 16, 2016, a hearing was held before the undersigned at One Centre Street, New York, New York, where testimony was taken and exhibits were admitted into evidence. The parties filed briefs after the hearing, the last of which was Respondent's Reply Brief, received on January 10, 2017. By letter dated February 24, 2017, Respondent submitted revised computations of the GCT due on combined returns. On March 7, 2017, a telephone conference was held to discuss the computations.

Petitioner, HMC-New York Inc, (Petitioner) was represented by Kenneth T. Zemsky, Esq. and Raymond J. Freda, Esq. of Andersen Tax LLC. Respondent, City Department of Finance, was represented

by Martin Nussbaum, Esq., Assistant Corporation Counsel, with the City's Law Department.

ISSUES

1. Whether Respondent's determination that Petitioner should have filed combined returns with related corporations for the Tax Years is correct.

2. If combination is required, whether Respondent's adjustment to the computation of non-officer compensation is correct.

3. If combination is required, whether Respondent's computation of receipts is correct.

FINDINGS OF FACT

1. Corporate Structure and Operations

Petitioner was incorporated on November 1, 2001 as a wholly-owned subsidiary of Harbert Management Corporation (HMC). HMC sponsored public equity and hedge funds (the Harbert Funds). A second wholly-owned subsidiary, Harbert Fund Advisors, Inc. (HFA)[1], was a registered investment advisor. A third wholly-owned subsidiary, HMC Investments, Inc. (HMC Investments), was a broker-dealer. HFA entered into investment advisory agreements with each of the Harbert Funds it advised, and derived fees based on a percentage of the funds' annual assets under management.

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[1]HFA was incorporated as The Harbinger Group, Inc., and changed its name to HFA in late 2004. It will be referred to as HFA herein.

Petitioner was based in the City; HMC, HFA, and HMC Investments were based in Birmingham, Alabama.

Petitioner entered into a written consulting agreement with HFA, dated November 1, 2001 (Consulting Agreement). Pursuant to that agreement, Petitioner was retained to advise HFA "in connection with hedge fund and investment matters including, but not limited to, providing general information relating to hedge fund market conditions, advising [HFA] in connection with employment initiatives, and assisting [HFA] in connection with investment strategies with regard to hedge fund investments . . . ." Pursuant to the Consulting Agreement, Petitioner was to render the following:

> "[S]uch services of an advisory or consultative nature as [HFA] may reasonably request, so that [HFA] shall have the benefit of its experience, knowledge, reputation and contacts in the hedge fund and investment industry, and [Petitioner] shall make itself and its employees available for advice and counsel to the officers and directors of [HFA] and its affiliates . . . ."

The Consulting Agreement acknowledges that Petitioner "may be simultaneously employed on a full or part time basis in other business endeavors not competitive with" HFA, and was "not to be expected to be available to [HFA] on a full-time basis but rather on a part-time basis, on reasonable notice from [HFA]'s representatives as provided herein." Paragraph 4(a) provides that Petitioner was to receive fees equal to 90% of its direct out-of-pocket costs related to the maintenance and staffing of its office.

The First Amendment to the Consulting Agreement, dated January 1, 2002, changed Petitioner's compensation to 100% of the

annual management fees HFA "received for Hedge Fund investment advisory services up to $2,500,000 annually, and thereafter, 90% of such annual management fees."

A second amendment, dated January 1, 2003, changed Petitioner's compensation, this time to 100% of the annual management fees which HFA received for investment advisory services provided to hedge funds operated out of Petitioner's offices (net of any portion paid directly by HFA to hedge fund managers) up to $2.5 million per year, and thereafter, 90% of such fees.

A third amendment made no change relevant here. The fourth and final amendment, dated January 1, 2004, changed the compensation so that Petitioner was to receive 66.67% of the annual management fees HFA received for investment advisory services provided to hedge funds operated out of Petitioner's offices. This amendment was in effect during the years at issue.

Five months prior to Petitioner's incorporation, by letter dated June 1, 2001, HMC hired Phillip Falcone to be senior managing director of one of its funds, at the fund's trading office in the City (Employment Agreement). Mr. Falcone had a base salary of $200,000 per year, and he and other members of his investment team were given the right to acquire interests in the general partner of the fund. By an assignment and consent dated November 1, 2001, the Employment Agreement was assigned by HMC to Petitioner.

Amendments to the Employment Agreement permitted participation in various funds. By letter dated December 15, 2005, Mr. Falcone and his management team were given the right to

participate in "Fund Level Net Profits" received by investment advisors. This was equal to Management Fee revenue less "direct fund operations and overhead expenses." For calendar year 2006, he and his team were allocated a percentage of the "Threshold Fund Level Net Profits" (defined as the first $35 million of Fund Level Net Profits), in the following amounts: 50% in 2006, 55% in 2007, and 60% for 2008 and later years. In addition, they were to be paid compensation equal to 67% of the Fund Level Net Profits in excess of $35 million.

John McCullough, executive vice president and general counsel of Petitioner's parent, HMC, testified that Petitioner leased office space in the City, provided marketing support, and was the employer of the investment teams based in the City, which "basically serve[d] as portfolio managers for certain hedge funds" (Tr 546:18-20). He analogized Petitioner's role to a common paymaster with respect to the transient investment teams. He stated that Petitioner also employed other employees who were part of its continuing business. He testified that compensation paid by HFA to Petitioner was designed to cover Petitioner's expenses and leave it with a reasonable profit. As Mr. McCullough explained, in 2008, Petitioner received 67% of HFA's gross management fees derived from managing the funds, while Petitioner paid Mr. Falcone 60% of management fee net profits, up to $35 million, and 67% above that. He further testified that Mr. Falcone did not take advice from anyone in making investment decisions. "That's what he was hired to do." (Tr 647.)

Michael Luce, vice chairman (and before that president and chief operating officer) of HMC, testified that Mr. Falcone and his team "managed the portfolio of investments. They selected securities and executed trades. They didn't do anything else.

They didn't raise the money, they didn't do the accounting, they didn't do risk management, they didn't do marketing investor reporting, any of that." He stated that those functions were performed by the "staff in Birmingham," meaning HFA or HMC (Tr 256:21 - 257:6). He also testified that Mr. Falcone took direction from the Birmingham office and was subject to its oversight. Mr. Falcone's employment ended in 2009, due to differences of opinion with the Birmingham office. Mr. Luce testified, "we could not come to a resolution of that disagreement, if you will. And we agreed that he should leave the company" (Tr 255:24 - 256:3).

Mr. McCullough testified that the losses for 2008 and subsequent years were created because the assets under management (AUM) of one of the funds "grew beyond anyone's wildest imagination" and thereby drastically increased the compensation paid to Mr. Falcone by animating "the accelerator feature" of his employment contract, whereby 67% of profits in excess of $35 million were paid (Tr. 572-73). When this feature was put into place in 2005, he stated, HFA had never had management net profits higher than the $35 million threshold. He averred that, "I don't think anybody could've reasonably imagined the spike in AUM that occurred in 2007 and 2008" (Tr 577:4-6).

Respondent provided as an exhibit data submitted by Petitioner in response to an information document request showing that HFA received management fees for 10 funds in 2008, 2009, and 2010 of $264,207,117, $5,019,472, and $2,523,870, respectively. The 66.67% paid to Petitioner for these years was $176,138,078, $3,346,314, and $1,682,581, respectively.

Petitioner was the managing member of the general partner of some of the funds.[2] Yet apparently only in the 2008 year did it derive anything beyond minimal fees for this. The federal consolidated corporation income tax return (Form 1120) reported "other income" in 2008 of $1,382,780, of which $1,359,678 was sourced to Harbert Capital Partners. "Other income" in 2009 and 2010 was $20,971 and $13,710, respectively.

Petitioner timely filed GCT returns. From 2001-2007, it reported positive taxable income in every year but 2002; for each of the Tax Years, it reported a loss.

For 2008, it reported a federal taxable loss[3] of $4,267,104 (income of $177,880,903 less deductions of $182,148,007, of which $158,164,000 was compensation of officers and $12,755,301 was salary and wages), and paid GCT of $9,104 based on its allocated capital. For 2009, it reported a federal taxable loss of $3,775,230(income of $5,547,252[4] less deductions of $9,322,482, of which $1,684,000 was compensation of officers and $3,125,260 was salary and wages) and paid minimum GCT of $3,500. For 2010, it reported a taxable loss of $2,414,036 (income of $2,212,575 less deductions of $4,626,611, of which $1,476,201 was

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[2]The Employment Agreement was assigned by HMC to Petitioner pursuant to a letter dated January 16, 2002 which stated in part, "[a]s you are aware, we organized HMC-New York, Inc. to act as the Managing Member of the General Partner of the Distressed Investment Fund . . . ."

[3]The computation of entire net income for GCT begins with federal taxable income.

[4]Gross receipts for 2008 and 2010 closely match the fees derived from the Consulting Agreement. However, for 2009, gross receipts reported on the consolidated U.S. Corporation Income Tax Return (Form 1120) were $5,352,689, and fees under the Consulting Agreement were $3,346,314. The source of the additional $2.2 million in addition to the amount paid pursuant to the Consulting Agreement was not disclosed.

compensation of officers and $446,089 was salary and wages), and paid minimum GCT of $1,500.

During these years, the Forms 1120 reported the following amounts of gross receipts (GR)(first line) and federal taxable income (before special deductions)(FTI)(second line) for Petitioner, HMC, HFA, and HMC Investments:

Corporation		2008	2009	2010
Pet'r	GR	176,140,078	5,352,689	1,682,581
	FTI	(4,267,104)	(3,775,230)	(2,414,036)
HMC	GR	28,597,932	25,006,625	19,941,103
	FTI	11,693,229	9,050,255	55,234,178[5]
HFA	GR	285,261,901	27,817,311	24,677,906
	FTI	65,285,455	(3,038,841)	(12,552,880)
HMC Inv	GR	3,600,000	3,600,000	2,000,000
	FTI	836,583	1,377,877	(28,983)

The audit workpapers list these intercorporate transfers:

	2008	2009	2010
HFA to HMC NY	176,140,078	3,456,698	1,682,581
HFA to HMC Inv	3,600,000	3,600,000	2,000,000
HFA to HMC	15,018,287	16,471,462	12,526,509
HMC NY & Inv to HMC	32,000	32,000	32,000

Comparing the Forms 1120 with the audit workpapers shows the following. Each year, more than 50% of Petitioner's receipts (excluding dividends, capital gains, and flow-through income) was

[5]In addition to gross receipts, HMC received dividends of $47,508,556 and "other income" of $4,451,626 in 2010.

paid by HFA.[6] Each year, all of HMC Investment's receipts and more than 50% of HMC's receipts were paid by HFA.

Sonja Keeton, HMC's executive vice president and CFO, testified that during Tax Years, she was controller and director of tax. She explained that the payment of wages to Petitioner's employees was handled by corporate parent HMC in Birmingham. She stated that Petitioner was set up as a common paymaster and to provide offices for traders. Despite the fact that Petitioner consistently listed its business as investment manager on its tax returns and in statements to Respondent, she maintained that it was in fact a common paymaster. She testified that HMC paid Petitioner's employees on its behalf. She explained that HMC was the legal employer of most of the employees of the group, and that the expense was then charged to HFA. There was no mark-up for this; it was simply allocated. She stated that there was markup of 8% for services performed by HMC employees for HFA.

Ms. Keeton testified that Petitioner filed its New York State corporation franchise tax return for its 2006 year on a separate basis and, after audit, the return was accepted as filed.[7]

She stated that Petitioner filed its New York State corporation franchise tax returns on a combined basis for the years 2007-2010. Petitioner was advised to do so by its tax

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[6]As stated in note 4, 100% of Petitioner's receipts came from HFA in 2008 and 2010. For 2009, its receipts were approximately $2 million higher than the amounts paid by HFA. The parties did not account for the source of this other income.

[7]The State Tax Law regarding combined returns for the 2006 year was the same as the City's Administrative Code provisions for the 2008 year. The amendments effective for the City for the 2009 year were effective for the State for the 2007 year.

adviser. She explained that Petitioner later believed that advice to be erroneous, but the cost of preparing an amended return dissuaded it from seeking a refund. The combined entities were the four here plus Harbinger Corporation. After examination, the returns for 2008 - 2010 were accepted as filed. The 2008 return reported a business allocation percentage of 1.2446%, based on New York receipts of $3,895,821, and total receipts of $313,015,997.[8] The basis of this computation was not disclosed.

2. Respondent's Audit

Respondent examined the GCT returns for the Tax Years. The auditor testified that he worked on the case with three different supervisors and that this was his first audit of a hedge fund. Asked what the basis was for concluding that combined returns were appropriate, he answered that when the case was first assigned to him, it contained a document from Respondent's Quality Control Group in which "they suggested a combination, based on information that they saw in the review of the tax returns. And so I simply followed through with that notion" (Tr 436:17-21). He testified that he followed his supervisor's suggestion that Mr. Falcone be treated as the only general executive officer, causing an adjustment in the payroll factor.

The audit supervisor testified that he determined that Mr. Falcone was the only general executive officer, based on a press release of the SEC indicating that he made all of the decisions.

[8]In 2008, New York State corporation franchise tax allocated business income based solely on receipts, while the City GCT used three equally-weighted factors: receipts, payroll, and property.

Following the audit, on December 20, 2013, Respondent issued proposed adjustments based on combining Petitioner with HMC, HFA, and HMC Investments. Respondent calculated the tax effect to be $3,699,993.67, of which $3,592,568.55 is for the 2008 year.

On January 28, 2014, Respondent issued revised audit adjustments, adding an adjustment "to New York City and Everywhere Payroll Factors to reflect a correction in the computation of non-officer compensation." It stated that only general executive officers are excluded from the factor and "[i]nformation available indicates that it was not accounted for correctly." The additional tax effect was $663,981.62.

On February 10, 2014, Respondent issued a "Consent to Audit Adjustment" that added a third adjustment: "In all periods, an ACRS adjustment add back and subtraction was made, in accordance with NYC Reg. Section 11-27." The additional tax effect was $175,356.02.

On May 13, 2014, Respondent issued the Notice of Determination, listing the three bases raised earlier, with amended amounts for the each of the three issues: $3,652,061.29 for the combination issue, $655,379.92 for the general executive officer issue, and $173,084.33 for the ACRS issue. The bulk of the asserted deficiency is in the 2008 year. The Notice of Determination asserts tax due of $4,345,530 in 2008, $118,121.13 in 2009, and $16,874.41 in 2010, for a total of $4,480,525.54. It also asserts interest due through June 30, 2014 of $2,202,692.06, for a total liability of $6,683,217.60.

Jerry Phillips, vice president and director of tax of HMC, was involved in the audit and testified to asserted computational errors in the Notice of Determination.[9] These issues were resolved by the parties after the hearing.

3. Expert Testimony

Both parties offered expert testimony. Petitioner offered the testimony of Emily Trader of Lattimore, Black, Morgan & Cain, P.C., as an expert on transfer pricing under Internal Revenue Code § 482. Respondent accepted her as an expert. She prepared a transfer pricing report, dated February 7, 2012 (Report), which Petitioner submitted to Respondent during the audit. The Report examined the fees HFA paid to Petitioner. It used the "comparable price method," which examines the average profit in transactions between unrelated parties, to see if the transaction to be examined fell within the middle 50% (two quartiles) of comparable values.

Ms. Trader testified that "HMC New York per agreement, I guess, with HFA provided investment consulting services on paper. But the substance of the company, as I understand it, it was set up to have a local presence in New York to hire and manage people, traders and others in New York . . . ." (Tr 311:16-25.) She viewed Petitioner as an employee leasing company because "[i]t employs people on behalf of others." (Tr 312:22-23).

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[9]He opined that Respondent (1) did not use the correct beginning and ending average property amounts in computing the property factor, (2) did not take into account passthrough receipts in computing the receipts and wages factors, (3) did not use the taxpayer's correct entire net income, (4) made an incorrect depreciation adjustment, (5) used federal taxable income after the dividends received deduction rather than before, (6) improperly computed capital, (7) failed to eliminate intercorporate transactions, (8) did not include all affiliated corporations in the combined group, and (9) sourced all HFA revenue to the City.

Accordingly, the comparables selected were not providers of financial services, but instead were providers of professional services such as advertising, legal services, research and development, management, and public relations.

The Report examines the five years beginning with 2004 and ending with 2008. It explains that:

> "The multi-period average test is generally the tested year (FY 2008) and the two prior years. Due to the global recession that began in late 2007 and continued through 2008 and beyond, we used a five year average of both the comparable company data and HMC NY data to evaluate transfer prices under the multi-period average test." (Report, p. 1787.)[10]

The Report states that a five-year period was used because "we are benchmarking arm's length returns to the company's consulting services using comparable companies from professional service firms (not financial service firms)" (Report, p. 1787).

The Report computed adjusted costs by subtracting the cost of "third party professional fees" and "the cost of the SMD [senior managing director] Profit Share (so as not to require a profit on top of profit sharing payouts) as these may be considered a third party cost - *and not a cost related to the actual provision of services rendered.*" (Report, p. 1788; emphasis added.) The "effective markup" was computed by dividing (i) the actual profit (revenue less actual expenses) by (ii) the profit calculated using adjusted costs (which subtracted fees for SMDs and professional fees). For example, in 2004, this method reduces operating costs from $27,436,126 to adjusted costs of $6,304,139. Actual profit (revenue of $33,217,645 minus actual

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[10]The Report contains the page numbers 1784 to 1802.

costs of $27,436,126 = $5,781,519) is then compared with adjusted costs of $6,304,139 to yield an effective markup of 91.7%.

The results showed effective markups for the years 2004 through 2008 of 91.7%, 17.0%, 23.3%, -9.3%, and -36.9%, respectively, with an average of 17.2%. The Report concludes that the appropriate range of profit among comparables is 6.6% to 16.6%, and that Petitioner's average effective markup of 17.2% is above this range, so that no adjustment is required.

Respondent introduced the testimony of Howard Radin, City Tax Auditor III. Mr. Radin has three bachelor's degrees from MIT, in economics, mathematics, and management, and developed software for transfer pricing. Most of his recent audit work focused on hedge funds. Petitioner accepted him as an expert in business analysis and consulting, the audit process, general audit processes, and transfer pricing analysis.

He testified that it made no sense to have a common paymaster in the City, a high-tax, high-expense jurisdiction. He maintained that as Petitioner's fees dropped from 90% to 66.67% of HFA's advisory fees, its expenses increased because of the change in the compensation agreement between Petitioner and Mr. Falcone. In his opinion, the "reward was distortively allocated" (Tr 890:23-24) "based upon the economic substance of what is happening" (Tr 891:3-4) because HFA was paid one-third of Petitioner's fees. "And what have they [HFA] done for it? Nothing. On the other hand, who earned the $100 million? The people in New York. That is distortive." (Tr 890:8-11). He believed it was inappropriate for Ms. Trader to remove bonuses from her computations, because such bonuses are a customary part of compensation in the industry.

He also believed that basing compensation on assets under management was "distortive" because "an entity could have a huge increase in value, more assets under management, but there could be no more work involved in doing it" (Tr 908:9-12). "So Harbert Funds Advisors is basically receiving huge amounts of extra income without doing a comparable amount of work - appropriate work to earn that income" (Tr 909:8-11). He testified that the "major distortion in the case is that . . . HFA received inappropriate compensation for services provided based upon the way they were calculated" (Tr 910:13-15).

4. Procedural Matters

The Petition was received on July 10, 2014. Respondent filed and served its answer dated October 3, 2014.

An initial conference was held on October 30, 2014. Ten telephone conferences were held after that, the last on November 4, 2015, at which the parties reported that they could not settle the case. It was set for hearing for eight days beginning June 6, 2016, with a final pre-hearing telephone conference set for May 24, 2016.

At the May 24 conference, Respondent's counsel stated that he believed the parties had settled the case and had learned the day before that they had not. Respondent's counsel requested an adjournment of the hearing, which was denied. Witnesses and exhibits were discussed and Petitioner's counsel stated that he intended to call Emily Trader as an expert witness. Respondent's counsel did not respond to this point. The parties agreed that they needed four rather than eight days for hearing and selected the dates of June 13-16, 2016.

On June 3, 2016, Respondent's counsel submitted a written request for an adjournment, citing two reasons. The first was that he had received what he described as a 25-pound box with 91 exhibits which he stated he needed more than five working days to review. The second reason was to allow time to retain an expert on transfer pricing, which he estimated would take six to nine months. Respondent's counsel stated that he had received Petitioner's pre-hearing memorandum which evidenced an intent to call two expert witnesses, Emily Trader, the author of the Report, and Peter Rabinowitz, formerly head of audit for Respondent. In the alternative, he requested keeping the record open to permit Respondent time to retain an expert. The motion for adjournment was denied and the motion to keep the record open was taken under advisement.

On June 16, 2016, the parties argued the motion to keep the record open. It was denied because Respondent had not begun the search for an outside expert; had presented the testimony of Howard Radin, whom Respondent had accepted as an expert; and because to retain such an expert and present the testimony would delay the case for at least another year, during which time interest would accrue on the asserted liability.

After the hearing on June 13-16, 2016, the parties filed briefs. Thereafter, Respondent made a submission, dated February 24, 2017, with revised computations of the GCT due on combined returns for the Tax Years. The submission addressed most of the computational errors about which Mr. Phillips testified.[11] The resulting tax asserted to be due for 2008, 2009, and 2010 was

[11]It corrected ENI to start with federal taxable income before the dividends received deduction, deducted 50% of the dividends received and reduced the receipts and property allocations for all years. It also computed capital each year based on the annual average, rather than year end.

$4,212,122.19, $88,152.37, and $170,208.69, respectively. This is a reduction in the first two years and a significant increase for 2010. During the March 7, 2017 telephone conference, Petitioner accepted the revised computations as correct, leaving three issues for decision: (1) whether combination is appropriate, and, if so, the correct computation of (2) the payroll factor and (3)the receipts factor.

POSITIONS OF THE PARTIES

Petitioner makes three arguments. First, on the issue of combination, while conceding that common ownership and a unitary business existed, Petitioner contends that there were not substantial intercorporate transactions. It argues that Petitioner served as a common paymaster and provided limited back office support to HFA. These services should be excluded from the computation of substantial intercorporate transactions.

It argues further that even if there were substantial intercorporate transactions, Ms. Trader's report and testimony establish that there was no distortion because the prices were comparable to arm's length transactions.

Second, Petitioner maintains that the payroll factor was overstated because Respondent excluded only one general executive officer from the computation, when in fact there were many. Petitioner's third point is that even if combination is required, the receipts factor was overstated because HFA's services were treated as if they were performed in the City, when in fact they were performed in Birmingham.

Respondent argues that there were substantial intercorporate transactions and that there was no evidence that Petitioner acted as a common paymaster or performed back-office functions. It argues that Petitioner's transfer pricing study is flawed because it is based on incorrect assumptions about Petitioner's business.

Respondent next argues that even if combination is not required under the distortion test, it is required under the alternative statutory basis of an arrangement, agreement, or understanding which causes an improper reflection of income.

Regarding allocation, Respondent argues that the majority of receipts for HFA were from services performed by Petitioner in the City.

CONCLUSIONS OF LAW

1. Combination

A. Overview

The petitioner has the burden of proof in contesting a notice of determination for GCT (Administrative Code § 11-680.5), except in certain cases, such as where Respondent asserts that a greater amount of tax is due than is set forth in the notice of determination.[12]

The statute regarding GCT combined tax returns was amended, so that the 2008 year is subject to rules that are different from those that applied in 2009 and 2010.

[12]Here, Respondent asserts increased tax due in the 2010 year and therefore has the burden of proof. However, Petitioner agreed to the changes which increased GCT for 2010, if combination is appropriate.

Generally, each corporation is a separate GCT-paying entity required to file its own tax return. However, in certain circumstances a corporation may be permitted or is required to file returns on a combined basis with related corporations.

For 2008, Respondent could require filing a combined return where (1) there was common ownership among the corporations (defined as 80% or more), (2) the corporations were engaged in a unitary business, and (3) either (a) filing on a separate basis "distorts" a taxpayer's income and thus GCT liability, or (b) there is an agreement, understanding, arrangement, or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected." (Administrative Code § 11-605.4; GCT Rules (19 RCNY) § 11-91 [e][1][ii], and § 11-92 [a][1] and [2].) A presumption of distortion exists where there are substantial intercorporate transactions between the members of a related group (19 RCNY § 11-91 [f]). "Substantial" is defined to be "where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities" (19 RCNY § 11-91 [f][3]).

Qualified activities are those directly connected with the business of the taxpayer, such as manufacturing or acquiring goods or property for other corporations in the group, selling goods acquired from related corporations, financing sales of other corporations in the group, and performing related customer services using common facilities and employees (19 RCNY § 11-91 [f][3]). "Service functions will not be considered when they are incidental to the business of the corporation providing such services. Service functions include, but are not limited to, accounting, legal, and personnel services" (*Id.*).

In order to overcome the presumption of distortion, the taxpayer must establish that the subject transactions were carried on at arm's length (*Matter of Toys "R" Us-NYTEX, Inc.*, TAT [E] 93-1039 [GC] [City Tax Appeals Tribunal, Appeals Division, 2004]; *Matter of Standard Manufacturing Co., Inc.*, DTA No. 801415 [New York State Tax Appeals Tribunal, 1992]; *Matter of USV Pharmaceutical Corp.*, DTA No. 801050 [New York State Tax Appeals Tribunal, 1992]).[13] These decisions accepted transfer pricing analyses pursuant to Internal Revenue Code § 482 to demonstrate arm's length pricing.

For 2009, the GCT statute was amended to require combined reporting "where the substantial ownership requirement is met and where there are substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions" (Administrative Code § 11-605.4[a]; *Matter of Kindercare Learning Corp.*, et al., DTA Nos. 823962 and 823963 [New York State Tax Appeals Tribunal, 2014] at p. 8, quoting from State Tax Law § 211 [4][a], which is identical to amended Administrative Code § 11-605.4 [a].) Further, combined reports may be permitted or required "even in the absence of substantial intercorporate transactions, when combined filing is necessary to properly reflect income and avoid distortion" (*Kindercare* at p. 9).

[13]As noted, the City's GCT statute regarding combined returns for the 2008 tax year was the same as New York State's statute for years up to 2005. The amendment to the State's statute effective for the years 2006 and following was the same as the amendment to the City's statute for years 2009 and following. (New York State Tax Law § 211 former and current [4][a].) This Tribunal is to follow as precedent the decisions of the New York State Tax Appeals Tribunal insofar as they pertain to substantive issues before us (City Charter § 170[d]).

B. 2008

In 2008, there were substantial intercorporate transactions. 100% of Petitioner's gross receipts and 100% of HMC Investment's gross receipts were paid by HFA. More than 50% of HMC's gross receipts were paid by HFA. Thus, there were substantial intercorporate transactions between HFA and each of the three other corporations Respondent sought to combine in each of the Tax Years.

Petitioner points out that dividends and incidental service functions are excluded from the substantial intercorporate transaction analysis (19 RCNY § 11-91[e][2] [iii] Example 3, *Matter of American Banknote Corp.*, TAT[E]03-31, TAT[E]03-32, and TAT[E]03-33[GC] [City Tax Appeals Tribunal, Appeals Division, 2010]; 19 RCNY § 11-91[e][3]). However, no dividends were present here. Nor did Petitioner demonstrate that the payments were for incidental services or attempt to quantify such amounts. On the contrary, the Consulting Agreement between Petitioner and HFA states that Petitioner is providing consulting services; it does not mention administrative or back office functions. There was no evidence that Petitioner was a common paymaster or otherwise performed administrative functions. Any back office functions were performed in Birmingham, not in New York.

These substantial intercorporate transactions give rise to a presumption of distortion. This presumption may be overcome by expert testimony to establish that there was no distortion based on an analysis pursuant to Internal Revenue Code § 482.

The Report prepared by Petitioner's expert computed effective markup (profit computed as a percentage of adjusted costs) for the years 2004-2008 as follows:

2004	2005	2006	2007	2008
91.7%	17.0%	23.3%	-9.3%	-36.9%

It selects 11 comparable situations and finds the markup within the inter-quartile range (i.e., 25% - 75%) is 6.6% to 16.6%. Because Petitioner's average profit of 17.2% exceeds this range, the Report concludes there is no distortion.

The Report is not convincing, for at least three reasons. First, it reaches its result based on a five-year average, 2004 through 2008, despite the fact that Ms. Trader testified that a three-year average is the norm. If a three-year analysis (2006 through 2008) is used, Petitioner shows an average loss of 7.63%, which would be below the comparable range, so the test would be failed. If the three years reviewed were 2008 through 2010, the average loss appears to be approximately 85%.[14] If the five years ending with 2010 are used, the average loss appears to be approximately 48.4%, and for the years 2004-2010, a loss of 19%. In fact, it is critical to the Report's conclusion that it include 2004, which showed a 91.7% effective markup, and to not include later years, which show losses.

Second, the Report uses as comparables items which do not appear to be comparable. The financial services performed by

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[14]The source of the amounts used for incentive pay in the Report was not stated. The analysis performed by the undersigned for 2008-2010 used officers' compensation as a proxy for incentive pay, which results in a loss of 30.7% for 2008 (compared with the report's loss of 36.9%), a loss of 58.3% for 2009, and a loss of 161.6% for 2010.

Petitioner differ from the legal, advertising, research, and other services selected in the Report. Exhibit 3 to the Report demonstrates this. It shows the markup of costs of the 11 comparable companies for 2004 through 2008, and none of them shows the huge swing from high effective markup to high loss exhibited by the Petitioner. Ten of them show little variation from year to year, and the eleventh varies from 28.2% in 2004 to -10.4% in 2008, nothing like the much larger change in Petitioner (from 91.7% to -36.9%). This calls into question how comparable the alleged comparables really are.

Third, it was not satisfactorily explained why bonuses would not be included in the analysis, since such compensation appears to be usual and customary in the industry. The explanation was that these were independently negotiated with the SMDs, so they are by definition arm's length, and therefore may be excluded. If these are not subtracted, the actual costs are substantially higher, increasing the denominator of the effective markup computation, and reducing the effective markup.[15]

For the proposition that bonuses are to be excluded, the Report relies on the disaggregation concept found in Treasury Regulation (26 CFR) § 1.482-9 (l)(4). This section states that, "A controlled services transaction may be analyzed as two separate transactions for purposes of determining the arm's length consideration, if that analysis is the most reliable means of determining the arm's length consideration for the controlled

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[15]For example, as noted, for the 2004 year, actual costs were $27,436,126, the "Profit Split" (incentive pay) was $20,991,315 and professional fees were $140,672. Subtracting the second and third items from the first results in "adjusted costs" of $6,304,139. The revenues of $33,217,645 less the actual costs of $27,436,126 results in a profit of $5,781,519. The "effective markup" is computed by comparing this profit with adjusted costs ($6,304,139), so it equals 91.7%. If the profit were compared with actual costs, the result would be 21%.

services transaction." There follow two examples, numbers 20 and 21. In the first, it can be determined that two distinct services were rendered, and two different methods of analysis can be used to determine the arm's length price. In the second, one company performs administrative services for another, for which it purchases software. The example concludes that it may be appropriate to use different analyses that account for the costs and the software.

What has not been demonstrated, as is the case in the regulation's examples, is that there are two separate transactions. How can the individuals who perform the services be considered a separate transaction from the provision of the services?

Respondent's expert raised a good point, which neither the Report nor Ms. Trader addressed. HFA was compensated 33.3% of the fees generated in the New York office, which paid for back office support. The transfer pricing study might have looked at the average cost of such support to see if it was reasonable, but it did not. For these reasons, the Report failed to rebut the presumption of distortion.

C. 2009 and 2010

For the 2009 and 2010 years, combination was required where there was common ownership, and substantial intercorporate transactions. In 2009, Petitioner earned more than 50% of its receipts (apart from dividends, capital gains, and flow-through entities) from HFA. In, 2010, nearly 100% of Petitioner's gross receipts were paid by HFA. In both years, 100% of HMC Investment's gross receipts were paid by HFA, and over 50% of

HMC's gross receipts were paid by HFA. Therefore, combination is required.

The conclusion that combination is warranted makes it unnecessary to consider Respondent's alternative argument concerning distortion.

2. General Executive Officer Issue

Business income was allocated for GCT purposes during the Tax Years according to a three-factor formula consisting of payroll, receipts, and property (Administrative Code § 11-604.3[a][2]). The percentage of each of these within the City and everywhere was computed and a composite factor derived which was applied to entire net income to determine City taxable income.[16]

In computing the payroll factor, compensation paid to general executive officers was excluded (Administrative Code § 11-604-3 [a][3]). A general executive officer was defined to include the chairman, president, vice president, secretary, assistant secretary, treasurer, assistant treasurer, comptroller, and any other officer, charged with and performing general executive duties of the corporation.

For 2008 and 2009, Respondent treated only one individual, Philip Falcone, as a general executive officer of Petitioner. Because Mr. Falcone's employment ceased in 2009, Respondent

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[16]These factors were evenly weighted in 2008. For tax years 2009 and 2010, the receipts factor was given increasingly greater weight (40% and 46%, respectively) and the other factors each correspondingly less (30% and 27%, respectively) (Administrative Code § 11-604.3 [a][10]).

determined that there were *no* general executive officers in 2010. In reaching this conclusion, the auditor deferred to his supervisor's judgment. He testified:

"Q. Did you apply any independent judgment?

A. No, I was following his direction.

Q. Do you have any sense as to why Ira arrived at that analysis?

A. No, I'm really not sure exactly what he was thinking, not exactly."

(Tr 453:2-9).

The audit supervisor testified:

> "And in looking through the internet and researching information that was available publicly, we found that one of the persons, unfortunately I don't remember the name, had testified before the SEC stating that they work following the direction of Mr. Falcone, and that everything that the company did, HMC New York did, had to be approved by Mr. Falcone." (Tr 73:17-25).

The document referred to was not identified. However, in a complaint filed by the Securities and Exchange Commission against Mr. Falcone which was introduced as an exhibit, it was alleged that Mr. Falcone took the actions he did as "the senior managing director of the investment manager" pursuant to which he "exercised authority over the investment decisions for the funds and other investment-related activities, including those described herein" (Exhibit 2). It was not stated there (or elsewhere in the evidence before the Tribunal) that Mr. Falcone

was in substance the only general executive officer of Petitioner. Further, minutes of Petitioner's shareholder and directors' meetings disclose that Petitioner had numerous officers, appointed by the board of directors. The audit workpapers contain lists of the officers each year, many of whom were well compensated (though not as well as Mr. Falcone) and bear titles much like Mr. Falcone's. There appears to be no basis to not treat them as general executive officers.

Indeed, Respondent's theory, based on Internet probing rather than hard facts, results in the conclusion that Petitioner had *no* general executive officers in 2010. There is no rational basis for Respondent's exclusion of individuals from the general executive officer category. Respondent is directed to recompute the payroll factor accordingly.

3. Allocation of Receipts Issue

Respondent's computation of the receipts factor did not eliminate intercompany transfers. Respondent's computations treated the four corporations as if the receipts of each were independent of the others, when in fact there were significant intercompany transactions. For example, in 2008, HFA's $285,901,019 of receipts were allocated to the City and Petitioner's $176,140,078 of receipts, received solely from HFA, were also allocated to the City. Thus, $176,140,078 was counted twice and both times allocated to the City.

> "In the case of combined reports, intercompany business receipts -- receipts by any corporation included in the combined report from any other corporation included in such report -- are eliminated

in computing the percentage of business receipts within New York City" (19 RCNY § 11-65[f]; *see also* § 11-62).

The transfers from HFA to the other entities[17] were for services rendered by those entities. Petitioner rendered services in the City; the other corporations performed services in Birmingham. Services are sourced to the location where the services are rendered (Administrative Code § 11-604.3 [a][2][B]).

Therefore, the receipts for HFA should be determined by subtracting its transfers to the other companies, leaving $90,503,536[18], which should be allocated to Birmingham, where HFA's personnel are located.[19] This results in the following allocation of receipts for 2008:

	City	Everywhere	
Petitioner	176,140,078	176,140,078	
HMC Corp	0	28,597,932	
HFA	0	90,503,536	
HMC Inv.	0	3,600,000	
	176,140,078	298,841,546	= 58.94%

Respondent is directed to recompute the receipts factor for all Tax Years using the methodology set forth in 19 RCNY § 11-65[f], eliminating intercompany receipts, and using an allocation

[17]These are set forth at page 8.

[18]$285,261,901 - $176,140,078 - $3,600,000 - $15,018,287 = $90,503,536.

[19]It is not possible to determine how to deal with the $32,000 because the amounts transferred by Petitioner and HMC Investments cannot be ascertained. Because the amount is relatively small, it is disregarded.

reflecting the location where services were rendered, as set forth above.

ACCORDINGLY, IT IS DETERMINED that combined returns are required for each of the Tax Years, and that Respondent must recompute the payroll and receipts factors for all years. The parties reached agreement as to the other issues. The Petition is granted in part, and denied in part, and the Notice of Determination is sustained in part and cancelled in part.

Dated: April 27, 2017
New York, New York

/s/
David Bunning
Administrative Law Judge