New York City Tax Appeals Tribunal

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In the Matter of	:	DECISION
AMERICAN BANKNOTE CORPORATION;	:	
AMERICAN BANK NOTE CORP.;	:	TAT (E) 03-31 (GC)
AMERICAN BANK NOTE CO., INC.	:	TAT (E) 03-32 (GC)
AND COMBINED AFFILIATES	:	TAT (E) 03-33 (GC)
Petitioners.	:	

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American Banknote Corporation ("AB Corp.") in its own name and as successor-in-interest to USBC Holdings, Inc. ("Holdings") and American Bank Note Company ("ABN") (collectively "Petitioners") filed an Exception to a Determination of an Administrative Law Judge (the "ALJ") dated May 30, 2007 (the "ALJ Determination"). The ALJ Determination sustained three Notices of Determination (the "Notices") issued by the New York City Department of Finance (the "Department").[1] One of the Notices showed an overpayment of New York City General Corporation Tax ("GCT") in favor of AB Corp. for the short tax year beginning July 26, 1990 and ending December 31, 1990, and the twelve-month tax years ending December 31, 1991 and December 31, 1992 (collectively the "Tax Years"). A second Notice asserted a GCT deficiency against AB Corp. as successor-in-interest to Holdings for the Tax Years. The third Notice asserted a GCT deficiency against ABN and its combined affiliate for the Tax Years.

[1] American Banknote Corporation and the entity identified in the caption as "American Bank Note Corp." are the same entity. ABN is identified in the caption as American Bank Note Co., Inc. and in the Record as American Bank Note Company, Inc.

Petitioners appeared by Stephen L. Solomon, Esq., and Kenneth I. Moore, Esq., of Hutton & Solomon LLP. The Commissioner of Finance of the City of New York ("Respondent" or "Commissioner") appeared by Martin Nussbaum, Esq., Assistant Corporation Counsel, New York City Law Department. The Parties filed briefs and oral argument was held before this Tribunal. Commissioner Robert J. Firestone did not participate in this Decision.

United States Banknote Company L.P. (the "Partnership") was a privately-held limited partnership.[2] For more than 100 years, the Partnership was engaged in the security printing business and was the second largest printer of security documents in the United States. The Partnership's products included stock and bond certificates, foreign currency, travelers checks, food stamps, postage stamps and U.S. government Treasury checks. The Partnership was headquartered in New York City (the "City") and, together with its affiliates, operated printing facilities in Pennsylvania, Illinois, California, Massachusetts and Singapore.

The Partnership and its general partner[3] held an 85 percent partnership interest in Lasercard Company L.P. ("Lasercard"), a manufacturer and marketer of computer-generated identification card systems. The Partnership also owned a corporation named Monetary Management Corporation ("MMC"), a financial services company, and a securities printing business that the Partnership purchased in January 1989 from Jeffries Banknote Company.

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[2] The ALJ's Findings of Fact, although paraphrased and amplified herein, generally are adopted for purposes of this Decision. Certain Findings of Fact not necessary to this Decision have not been restated and can be found in the ALJ Determination. Petitioners take exception to a number of Findings of Fact made by the ALJ. We find that the ALJ's Findings of Fact accurately reflect the Record. Petitioners' exhibits are identified as "T. Ex._" (for "Taxpayers' Exhibit"). Respondent's exhibits are identified as "C. Ex._" (for "City's Exhibit").

[3] *See infra* note 6.

During 1989, the Partnership and its affiliates had sales of approximately $54 million and incurred a net loss of approximately $2 million.

Prior to the Tax Years, International Banknote Company, Inc. ("IBK"), was a publicly-traded corporation, also headquartered in the City. IBK was the largest printer of security documents in the United States at that time. IBK owned 100 percent of ABN and 80 percent of American Banknote Holographics, Inc. ("Holographics"). ABN, which had been engaged in the printing business since the 1700s, operated three printing facilities. Its products included stock and bond certificates, foreign currency, travelers checks, U.S. postage stamps, U.S. food stamps and passports. Holographics was then the world's largest producer of three-dimensional holograms used for security and product packaging applications. Holographics operated two facilities.

During 1989, IBK and its subsidiaries had sales of approximately $83 million and a net loss of approximately $4 million (excluding the gain on the sale of a minority interest in Holographics.)

Prior to 1989, the Partnership and IBK were the two largest companies competing in the security printing business in the United States. Due to a reduction in the volume of securities transactions and the development of electronic recordkeeping for securities, the business of printing securities and other similar documents had declined. As of December 31, 1989, the Partnership had total debt of $40,080,000, excluding accounts payable and accrued expenses, of which the long-term portion was $29,387,000. As of that same date, December 31, 1989, IBK had outstanding long-term debt and other liabilities of $23,231,000, of which $19,194,000 represented IBK's liability under 10¼ percent subordinated debentures, (the "Subordinated Debentures").

The financial condition of the Partnership and IBK prior to the Tax Years was the direct result of competition between them and with European companies, as well as a result of the declining market for printed securities. The Partnership and IBK determined that it would be in the best interests of both businesses to combine their operations. The Partnership and IBK signed a merger agreement, dated as of May 24, 1989, under which the companies were combined.

As a preliminary step, the Partnership made a tender offer for the stock of IBK (the "Tender Offer"). To facilitate the Tender Offer, the Partnership formed USBC Acquisition, Inc. ("Acquisition"), which purchased approximately 66⅔ percent, on a fully diluted basis, of the outstanding shares of IBK.[4] Following the Tender Offer, IBK formed Holdings as a wholly-owned subsidiary. Through a series of transactions, the operating assets of the Partnership and the security printing business it had purchased in 1989 were transferred to ABN, and the stock of ABN and Holographics and the partnership interest in Lasercard were transferred to Holdings.[5] Following the Tender Offer, Acquisition merged into IBK, which changed its name to United States Banknote Corporation ("USBC") in July 1990.[6] The foregoing transactions, including the Tender Offer, are referred to herein as the "Merger."

Following the Merger, the officers of USBC included the following individuals: Messrs. Weissman, Kreitman, Gorman, Cantor, Christophersen, Ivey and Reddy. The first five individuals were officers of the Partnership before the Merger. Mr. Ivey was an officer of ABN and Holographics before the Merger and Mr. Reddy was an officer of IBK before

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[4] Elsewhere in the Record, the amount of IBK stock purchased in the Tender Offer is described as 72 percent. C. Ex. E-1 at 18.

[5] Holdings also became the shareholder of other subsidiaries of IBK not at issue in this matter.

[6] A Delaware corporation that was the general partner of the Partnership prior to the Tender Offer also was named United States Banknote Corporation ("USBC Delaware"). In the series of transactions following the Tender Offer, USBC Delaware merged into Holdings.

the Merger. Except for Mr. Reddy, the executive officers of IBK before the Merger did not continue as officers after the Merger. Patrick Gentile, who testified for Petitioners at the hearing in this matter, was the corporate controller of IBK at the time of the Merger and later became the Executive Vice President and Chief Financial Officer of AB Corp.

Citibank provided financing for the Merger in the form of loans (the "Loans") of more than $119 million.[7] Additional funding came from cash belonging to IBK and the proceeds from the sale of certain assets.[8] The costs of the Merger included: the purchase of the IBK stock for approximately $76 million; replacing approximately $43 million in liabilities of the merged companies; and fees and transaction expenses of approximately $12 to $13 million.

As a condition of making the Loans, Citibank required all pre-existing indebtedness of the companies, other than the Subordinated Debentures, to be removed and limited the ability of the companies to incur any additional debt.

Citibank also required the stock of ABN and Holographics (the "Operating Companies") to be held unencumbered by a new entity, *i.e.,* Holdings. The Loans were secured by perfected security interests in the stock of Holdings, its assets, the assets of its subsidiaries and any intercompany indebtedness. The Loans were guaranteed by USBC and the Operating Companies. Citibank required Holdings to be the primary obligor on the Loans so that Citibank could liquidate the assets of Holdings to repay the Loans in the event

[7] Citibank initially funded the Tender Offer through loans of approximately $119.6 million plus a $14 million bridge loan. Citibank provided permanent financing for the Merger of $119.3. The stock of MMC was sold and the proceeds used to repay the $14 million bridge loan. T. Ex. 10 at 13. A facility in Ramapo, NY also was sold at the insistence of the United States Department of Justice but the proceeds were comparatively nominal. Tr. 177, 180; T. Ex. 10 at 9, 14.

[8] T. Ex. 10 at 13-14.

of a default.

The Loans included a revolving credit facility for post-Merger working capital of approximately $10 million. The cash flow report included in Petitioners' annual report to the Securities and Exchange Commission (Form 10-K) for 1992[9] showed that the following amounts were drawn down on that facility for working capital: $2,321,000 for 1990; $1,350,000 for 1991 and $2,850,000 for 1992.

Holdings could not pay the debt service on the Loans from its own limited income.[10] Rather, Holdings used funds transferred to Holdings from the Operating Companies to service the Loans. Mr. Gentile described the transfers of funds from the Operating Companies to Holdings to pay the debt service on the Loans as sweeps. Petitioners treated these transfers as intercompany loans but those loans were not documented through written loan agreements and no interest was charged or paid on the loans.

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[9] T. Ex. 2-c.

[10] On Petitioners' 1990 federal consolidated income tax return, Holdings reported no income from sales and only $24,158 in interest income, $20,833 in management fees and $222,012 of partnership income. For that same year, Holdings reported $8,460,381 in interest expense. On Petitioners' 1991 federal consolidated income tax return, Holdings again reported no income from sales and reported only $18,782 in interest income, $8,334 in management fees and $61,938 in partnership income. For that year, Holdings reported $16,940,546 in interest expense. For 1992, Holdings reported no income and interest expense of $5,054,629. In 1992, USBC also had interest expense of $8,993,764 because Holdings merged into USBC in the middle of that year.

Citibank also required a portion of any excess cash flow and the proceeds of any sale of assets of the Operating Companies or Holdings, other than a sale in the ordinary course of business, to be used to repay the Loans.[11]

Prior to the Merger, in addition to offices in the City, the Partnership and its affiliates operated the following domestic printing facilities: Caroline Road, Philadelphia, PA (which produced travelers checks, food stamps and web intaglio special products); 55th Street, Philadelphia, PA (which produced stock and bond certificates); Forest Park, IL (which produced U.S. Treasury checks and currency); and Los Angeles, CA (which produced travelers checks and currency.) Prior to the Merger, in addition to its offices, ABN operated the following domestic printing facilities: Horsham, PA (which produced travelers checks and food stamps); Ramapo, NY (which produced stock and bond certificates); and Bedford Park, IL (which produced stock and bond certificates, commercial printings, postage stamps and web intaglio special products.)

In connection with the Merger, Petitioners consolidated their operating facilities. As part of the consolidation, six of the domestic printing facilities were consolidated into plants producing similar products to maximize the efficient use of personnel while maintaining geographic distribution. As a result, the number of domestic plants and employees was reduced. The Horsham, PA, Bedford Park, IL and Los Angeles, CA plants were retained.[12] Following the Merger, the executive, administrative and sales offices in the City also were retained.

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[11] For example, in 1990, Citibank required ABN to sell certain archival plates at auction to pay down a portion of the Loans. Tr. 206; T. Ex. 10 at 87.

[12] The holographic facilities in New York and Pennsylvania belonging to Holographics also were retained as were a facility in Singapore and Lasercard's facility in Massachusetts.

In 1992, the United States Postal Service awarded Petitioners a contract to print postage stamps that required additional funding of $20 million. Because Citibank was unwilling to provide the additional funding, USBC made a public offering of debt and equity securities to raise sufficient funds to repay the Loans and to provide the necessary funds to fulfill the government contract. After repayment of the Loans, Holdings was merged into USBC on May 26, 1992. In 1995, USBC changed its name to American Banknote Corporation.[13]

For the Tax Years, USBC, Holdings and the Operating Companies were included in federal consolidated income tax returns.[14] On those federal consolidated returns, the activities of USBC and Holdings were variously reported to be "holding company" and "financing/investment". The activity of ABN was reported as "printing" and the activity of Holographics was reported as "holography". Holdings reported interest expense of $8,460,381 for the Tax Year ending December 31, 1990, $16,940,546 for the Tax Year ending December 31, 1991, and $5,054,629 for the Tax Year ending December 31, 1992.[15]

For the Tax Years, USBC, Holdings and the Operating Companies filed combined GCT returns. For the Tax Years, the various companies included in the combined GCT returns reported the following separate results on pro forma returns, Form 3L, attached to the combined GCT returns filed on Form 3A:

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[13] Although USBC became AB Corp. in 1995, that corporation will be referred to from this point on as USBC because that was its name during the Tax Years.

[14] The federal consolidated returns included several subsidiary corporations not included in the combined GCT returns. Many of these corporations were described in the federal returns as inactive. Some were non-U.S. corporations. The federal returns filed by Petitioners for the Tax Years used the employer identification number of USBC Delaware (*see supra* note 6) and the GCT returns used the employer identification number of USBC although the corporation filing all of those returns was USBC.

[15] Because Holdings was merged into USBC in the middle of 1992, USBC also reported interest expense of $8,993,764. USBC only reported nominal amounts of interest expense in 1990 and 1991.

Tax Year	Name	Entire Net Income (Loss) before NOL
1990	USBC	($882,178)
1990	Holdings	($10,007,279)
1990	Holographics	$2,034,784
1990	ABN	$2,811,006
1991	USBC	($301,220)
1991	Holdings	($16,855,461)
1991	Holographics	$7,619,102
1991	ABN	$11,280,759
1992	USBC	($23,081,884)
1992	Holdings	($5,226,511)
1992	Holographics	$6,764,882
1992	ABN	$19,959,122

USBC and Holdings reported no wages during the Tax Years. ABN, Holographics and Lasercard had their own employees and officers. The officers of USBC and Holdings were paid by ABN. For the Tax Years, ABN and Holographics paid compensation to officers as follows:

Tax Year	Name	Compensation Paid
1990	ABN	$437,340
1990	Holographics	$611,203
1991	ABN	$1,875,833
1991	Holographics	$285,205
1992	ABN	$2,804,716
1992	Holographics	$204,062

In 1994, the Department began an audit of Petitioners (the "Audit") for the tax years beginning July 26, 1990 and ending December 31, 1993 but the Audit was later limited to the Tax Years.

The Department determined that during the Tax Years, USBC and Holdings were passive holding corporations that should be excluded from the combined GCT returns of Petitioners and that each should be required to file a separate GCT return for each of the Tax Years. The Department also determined that interest expense and other deductions claimed by Holdings were directly attributable to subsidiary capital and should not be deductible. Finally, the Department concluded that ABN and Holographics were engaged in a unitary business and shared facilities, a customer base and officers and, therefore, should be permitted to file combined GCT returns for the Tax Years.[16]

The Department recomputed the GCT liability of USBC for the Tax Years ending December 31, 1990 and 1991 to consist of the tax on allocated capital and for the Tax Year ending December 31, 1992 to consist of the tax on allocated net income, plus, for each Tax Year, the tax on allocated subsidiary capital. The Department recomputed the GCT liability of Holdings for each of the Tax Years to consist of the minimum tax plus the tax on allocated subsidiary capital. The Department recomputed the GCT liability of ABN and Holographics for each of the Tax Years to consist of the tax on their combined entire net income.

[16] Other Audit adjustments that are not in dispute included the disallowance of certain losses and deductions, the application of net operating losses, the disallowance of certain wage deductions by Holdings and the disallowance of certain deductions attributable to subsidiary capital.

Following the Audit, the Department issued the Notices as follows:

Name	Principal Amount of GCT Due/(Overpaid)	Date of Notice
American Bank Note Co Inc. and Combined Affiliate	$512,426.65[17]	December 14, 2001
American Bank Note Corporation Successor-in-interest to USBC Holdings	$6,095.23	December 18, 2001
American Banknote Corp. (F/K/A United States Banknote Corp.)	($18,436.19)[18]	December 18, 2001

Interest was computed on each of the amounts to December 31, 2001. No penalties were asserted.

The ALJ sustained the Notices concluding that USBC and Holdings (the "Holding Companies"), were not engaged in a unitary business with the Operating Companies and, therefore, could not be included in a combined GCT return with them.

Petitioners take exception to the ALJ's conclusion that the Holding Companies were not part of the unitary business conducted by the Operating Companies. Petitioners assert that the Holding Companies, as the sole source of financing for the Merger and working capital, "played an essential and integral role in" the Merger and reorganization of the

[17] By a letter dated December 10, 2004, the Department reduced the GCT deficiency asserted against ABN and combined affiliate to $481,100.

[18] By a letter dated November 1, 2005, the Department increased the amount of the overpayment reflected on the Notice issued to AB Corp. to $24,781.40.

business operations of the Operating Companies "that allowed the group to successfully compete" in the security printing business. Petitioners' Brief at 13-14. Petitioners argue that because the Holding Companies did not compensate the Operating Companies for the use of funds to service the Loans and because the Holding Companies did not charge the Operating Companies for the working capital provided to them, the income of both groups is distorted and combination is necessary to properly reflect their income during the Tax Years.

Respondent takes the position that Citibank required the Merger to be structured as an investment by the Holding Companies in the stock of the Operating Companies to put that stock, as collateral for the Loans, beyond the reach of other creditors of the business and, therefore, the investment nature of the structure should be respected. Respondent argues that the Holding Companies were pure holding companies and not participants in a unitary business with the Operating Companies. Respondent further argues that to permit the Holding Companies to be included in a combined return with the Operating Companies would distort the Operating Companies' income because the Merger merely facilitated a passive investment by the Holding Companies.

For the reasons set forth below, we reverse the ALJ Determination and cancel the Notices except to the extent they reflect undisputed Audit adjustments that would apply to Petitioners' combined GCT returns for the Tax Years.

Under §11-605.1 of the Administrative Code of the City of New York (the "Code"), "[e]very corporation having an officer, agent or representative within the [C]ity" is required to file an annual return on the 15th day of the third month following the close of the corporation's taxable year. Section 11-91(a) of the Rules of the City of New York relating to the GCT (the "GCT Rules") emphasizes that "[e]very corporation is a separate taxable entity and shall file its own report." 19 RCNY §11-91(a). However, Code §11-605.4 provides that the Commissioner has the discretionary authority to permit or require two or more corporations to file combined GCT returns if certain stock ownership and other requirements are met. The GCT Rules elaborate on the circumstances under which a group of corporations can file a combined return. 19 RCNY §11-91. In addition to the stock ownership test, which is not at issue in this case, the GCT Rules require the group of corporations to be engaged in a unitary business and require a determination that separate reporting by the members of the group distorts the activities, business, income or capital in the City of those members of the group that would be GCT taxpayers if viewed separately.

The GCT Rules provide that in determining whether the unitary business requirement is met for any member of a group of corporations, the Commissioner will examine how the activities of that corporation relate to the activities of the other members of the group. Examples of unitary activities are:

- manufacturing or acquiring goods or property or performing services for other members of the group,
- selling goods acquired from other members of the group, or
- financing sales of other members of the group.

The Commissioner also will consider whether the members of the group are engaged in the same or related businesses, for example manufacturing or selling similar products or services or having common customers. The GCT Rules contain an example in which a manufacturing corporation forms a holding company whose sole activity is to hold the stock of the manufacturing corporation and to receive dividends from it. 19 RCNY §11-91(e)(2)(iii) Example 3. That example concludes that the holding company and the manufacturing corporation are not engaged in a unitary business. Example 7 in 19 RCNY §11-91(f)(6) similarly provides that a holding company whose sole activity, apart from paying dividends to its shareholders, is to receive dividends from three subsidiaries is not engaged in the unitary business conducted by the three subsidiaries.

Well-established case law identifies the characteristics of a unitary business as "functional integration, centralized management, and economies of scale." MeadWestvaco Corp. v. Ill. Department of Revenue, 40 U.S.L.W. 4193, 4197 (U.S. April 15, 2008); Matter of Panavision, Inc., New York State Tax Appeals Tribunal (June 6, 2002) ("Panavision"). The Supreme Court also has held that the "functional meaning" of the term "unitary business" is "some sharing or exchange of value not capable of precise identification or measurement - beyond the mere flow of funds arising out of a passive investment or a distinct business operation . . ." Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 166 (1983). The question presented by this case is whether the Holding Companies were participants in the unitary business of the Operating Companies or were deriving a "mere flow of funds arising out of a passive investment . . ." *Id*.

While there is a substantial body of case law in New York on the question of whether a group of corporations is engaged in a unitary business, only two cases involved an operating subsidiary and a parent holding company that had no business operations of its own. In Matter of Autotote Limited, New York State Tax Appeals Tribunal (April 12, 1990) ("Autotote"), the New York State Tax Appeals Tribunal (the "State Tribunal") found that a parent holding company was engaged in a unitary business with its operating subsidiary. Before the years in question in that case, the holding company had borrowed approximately $16 million to purchase the operating subsidiary in a leveraged buyout. The State Tribunal found that the holding company had no employees or offices of its own; rather it relied on the personnel and offices of the operating subsidiary for all its activities. The corporations had identical officers and directors. The holding company refinanced its original debt and loaned the $14.6 million net proceeds of the refinancing to the operating subsidiary. Of that amount, the operating subsidiary used $7.8 million to reduce the acquisition debt, $5 million to reduce equipment lease financing, $730,000 to purchase buildings later leased to the operating subsidiary, and the balance for working capital. Although the third-party debt was refinanced several times, the corresponding debt between the operating subsidiary and the holding company remained the same. The State Tribunal concluded that while the holding company did not manufacture or purchase goods for the subsidiary or sell products or finance sales of the subsidiary, it was engaged in a unitary business with the subsidiary because it financed the operations of the subsidiary.

Panavision involved a parent holding company of an international group of corporations engaged in manufacturing and distributing lighting equipment for the motion picture, television, theater and studio production industries. The parent holding company purchased the stock of Panavision, Inc., which was engaged in the manufacture and sale of cameras for the motion picture and television industries. The parent holding company had borrowed $340 million of which $110 million was used to purchase Panavision, Inc. and the rest for other group purposes. The Panavision, Inc. stock, along with the stock of the other group members, was pledged as security for the debt. Panavision, Inc. generated substantial cash that was distributed to the parent holding company and used to finance the operations of the rest of the group, including servicing the debt. Panavision, Inc. had no debt of its own and was not compensated by the parent holding company or any other member of the group for use of those funds. The State Tribunal found that Panavision, Inc. was not engaged in a unitary business with the rest of the group. The State Tribunal found that Panavision, Inc. derived no value from the management by officers of the parent holding company. While officers of the parent holding company oversaw Panavision, Inc., that oversight was related to the financing concerns of the parent holding company, including the flow of cash from Panavision, Inc., and did not amount to the kind of centralized management required for a unitary business. The State Tribunal noted that Panavision, Inc. had its own management team that was responsible for day-to-day operations. The State Tribunal found no significant evidence of economies of scale in the operations of Panavision, Inc. and the rest of the group. Finally, the State Tribunal agreed with the State Administrative Law Judge's conclusion that the parent holding company acquired Panavision, Inc. as an investment rather than to further the business operations of the group and, therefore, the pledge of Panavision, Inc.'s stock to secure the parent holding company's debt did not constitute a flow of value between the entities that would support a finding of a unitary business.

Petitioners argue that Autotote should control the outcome in this case while Respondent argues that Panavision should control. The present case has elements of each. As in Autotote, all but one of the officers of the Holding Companies were originally officers of the Partnership or the Operating Companies prior to the Merger and all were paid by the Operating Companies during the Tax Years, and not by the Holding Companies. All of the activities of Holdings were carried out by personnel of the Operating Companies. The Holding Companies shared the City offices of the Operating Companies. Holdings was formed at the direction of Citibank to facilitate the leveraged buyout of ABN and Holographics. However, unlike Autotote, none of the proceeds of the Loans were loaned to the Operating Companies.

This case also resembles Panavision in that all available cash flow from the Operating Companies was "swept" up to the Holding Companies and used to pay debt service on the Loans. We agree with the ALJ that these sweeps were dividends to the Holding Companies and not intercompany loans.[19] However, unlike Panavision, the present case contains ample

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[19] We also agree with the ALJ that the Holding Companies were not the type of financing affiliates of the Operating Companies that have been held to be part of a unitary business. *See, e.g.,* Matter of Sears, Roebuck and Co., New York State Tax Appeals Tribunal (April 28, 1994).

evidence of the benefits that the Operating Companies derived from the Merger. Unlike Panavision, Inc., ABN and Holographics, and the Partnership and its affiliates all experienced operating losses in the period before the Merger as a result of their mutual competition. Respondent does not dispute the economies of scale achieved in the Merger by eliminating duplicate facilities and staff. Respondent permitted the Operating Companies to file a combined return for the Tax Years. The Merger was not merely part of an overall investment strategy on the part of the Partnership. Rather the Merger was necessary to the continued viability of the two competing groups of companies in a specialized and shrinking industry.[20]

The Record indicates that a single medical plan and general liability insurance policy covered all of the companies in the group and all annual reports and tax returns were centrally prepared. Although Holdings was created to facilitate the financing of the Merger, IBK had existed as the parent corporation of ABN and Holographics. However, only one of the officers of IBK prior to the Merger, Mr. Reddy, continued as an officer afterwards. The rest were replaced by individuals from the Partnership or the Operating Companies who continued to be paid by the Operating Companies following the Merger. T. Ex. 10 at 87-88, 115-16. Thus, while there was centralization of management during the Tax Years, that management was provided by the Operating Companies, not the Holding Companies. There is no evidence in the Record as to how much time those individuals devoted to the activities of the Holding Companies as opposed to the operations of the Operating Companies.

Citibank required the Operating Companies to be held by a newly-formed special purpose entity, *i.e.,* Holdings, as a condition of its commitment to make the Loans and

[20] While some affiliates of both IBK and the Partnership were engaged in businesses unrelated to the security printing business, the latter business was the primary activity of each group at the time of the Merger.

required Holdings to be identified as the borrower on the Loans. We do not consider the fact that the Operating Companies provided funds to the Holding Companies to pay the debt service on the Loans through dividends rather than intercompany loans to be inconsistent with a unitary business in this case.[21]

Respondent concedes that the portion of the Loans comprising working capital for the Operating Companies represented a flow of value from the Holding Companies to the Operating Companies but Respondent contends that these amounts were de minimis and insufficient to create a unitary business.[22] However, Respondent ignores the larger flow of value in the form of debt refinancing. As discussed in more depth below, more than $40 million of the Loans represented refinancing of pre-Merger liabilities of the Partnership and the Operating Companies. Economically we see no difference between a re-lending of borrowed funds from a parent to a subsidiary, as occurred in Autotote, and the assumption by the parent of liabilities of the subsidiary, as occurred here. The refinancing of pre-Merger debt comprises a flow of value between the Holding Companies and the Operating Companies beyond the mere pledge of the stock of the Operating Companies as collateral for the Loans. In this regard, the present case differs from Panavision.

Because the Merger was essential to the continued economic viability of the Operating Companies and the holding company structure was dictated by the third-party lender of funds required to accomplish the Merger, and because the activities of the Holding Companies were carried out by the management of the Operating Companies, we conclude that there

[21] Even if intercompany loans had been recorded on Petitioners' books, the Holding Companies had no separate source of funds to repay any loans from the Operating Companies and the same individuals made all of the management decisions for the Operating Companies and the Holding Companies. Therefore, intercompany receivables would constitute meaningless bookkeeping entries under the circumstances.

[22] *See* Matter of Toys "R" Us-Nytex, Inc., TAT (E) 93-1039 (GC) New York City Tax Appeals Tribunal (January 14, 2004).

was functional integration between the Operating Companies and the Holding Companies. We note further that when it became necessary in 1992 to refinance the Loans through a public offering, USBC, as a public company, was better positioned to do that than the Operating Companies.

For the foregoing reasons, we find that the Holding Companies were part of the unitary business conducted by the Operating Companies. We emphasize that our conclusion relies heavily on the specific facts of this case. We do not go so far as to conclude that every holding company of a controlled group of subsidiaries engaged in a unitary business is part of that unitary business as some have advocated.[23] Nor are we invalidating the examples in the GCT Rules cited above.

The existence of a unitary business alone does not support combined filing for GCT purposes. We also must examine whether separate filing by the Holding Companies and the Operating Companies results in distortion.[24] We note that combination is not the only mechanism to correct distortion available under the Code. Code §11-605.5 permits the Commissioner to "adjust items of income, deductions and capital" to properly reflect a corporation's "activity, business, income or capital" in the City or to make adjustments to the income of a taxpayer to correct the effects of non arm's-length transactions between the taxpayer and related parties. The Parties have not argued in the alternative that any distortion resulting from separate filing by the Holding Companies and the Operating Companies might be corrected through an adjustment under Code §11-605.5 rather than through combination. The Record does not contain sufficient information to enable us to make any such adjustment

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[23] *See,* Jerome R. Hellerstein & Walter Hellerstein, State Taxation I Constitutional Limitations and Corporate Income and Franchise Taxes 8-212-13 (Warren, Gorham & Lamont, 3d ed. 2000) (1992).

[24] While in a given case, the same intercompany activities may support a finding of unitary business and distortion, these are separate requirements. *Cf.* Autotote.

and we will not remand this matter to the ALJ for additional proceedings that would amount to a re-audit on the record. Therefore, we need not address whether Code §11-605.5 authorizes an adjustment to correct any distortion resulting from a separate filing by the Holding Companies and the Operating Companies.

The GCT Rules provide that the distortion requirement for combination will be presumed to be met where there are "substantial intercorporate transactions" among the corporations. 19 RCNY §11-91(f)(1). For this purpose, only transactions directly connected with the business will be considered and not incidental service functions such as accounting, legal and personnel services.[25] Intercorporate transactions will be considered substantial where they result in 50 percent or more of the receipts or expenses of a corporation. 19 RCNY §11-91(f)(3). We agree with the ALJ that the sweeps of funds from the Operating Companies were dividends and that there were no substantial intercompany transactions that would support a presumption of distortion in the present case.

However, the GCT Rules make it clear that the presumption of distortion is not conclusive. Where substantial intercorporate transactions exist, if separate filing is not distortive, combination will not be permitted or required. Conversely, where substantial intercompany transactions do not exist but separate filing is, nevertheless, distortive, combination will be permitted or required. 19 RCNY §11-91(f)(4).

Petitioners argue that to deny the Operating Companies any deduction for the interest on the Loans incurred to effect the Merger is distortive because the funds used to pay that interest came from the Operating Companies. Respondent argues that the Loans were incurred by the Partnership to make an investment in the stock of ABN and that it would be

[25] Although those service functions are relevant in determining whether the centralization of management necessary to a unitary business exists.

distortive to allow a deduction for interest against the income of the target of the acquisition. Respondent's Reply Brief at 23. Code §11-602.8(b)(6) disallows a deduction for interest directly or indirectly attributable to subsidiary capital. Respondent argues that this provision would be rendered meaningless if a parent corporation could satisfy the requirements for combination merely by borrowing to purchase a subsidiary. We agree. However, this does not mean that combination is never appropriate when a parent corporation borrows to buy the stock of a subsidiary.

The "Sources and Uses of Funds" section of the proxy statement filed by IBK in connection with the Merger (the "Proxy Statement")[26] states that the funds used in the Tender Offer consisted of two loans, a $119.6 million Tender Offer Facility and a $14 million bridge loan.[27] T. Ex. 10, at 14. Of the total amount of that debt, $76 million was used to purchase the stock of IBK in the Tender Offer, $42.7 million was used to "refinance certain existing indebtedness and leases",[28] $5 million was for working capital and the balance was for fees and expenses of the transactions and for interest reserves. T. Ex. 10, at 14. This breakdown resembles that in Autotote where of the $14.6 million in net refinancing proceeds, $7.8 million was used to reduce the acquisition debt, $5 million to reduce equipment lease financing in the operating subsidiary and $730,000 to purchase buildings used by the operating subsidiary. In both instances, more than half of the proceeds was used to finance or refinance the purchase of the target subsidiary but a sizeable portion was used to refinance pre-acquisition debt incurred by the operating target subsidiary.

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[26] T. Ex. 10.

[27] The Tender Offer Facility was refinanced with $119.3 million in "Merger Facilities" and the bridge loan was repaid with $14 million received in the sale of MMC.

[28] The Record does not contain a specific breakdown of this amount between refinanced debt and leases. Other exhibits indicate that the amount of lease obligations in the Partnership and the Operating Companies was relatively small. *See, e.g.,* T. Ex. 10, at 93 (pro-forma capital lease obligations of $2.015 million as of 3/31/1990), F-21 (capital lease obligation of $2.861 million as of 12/31/1989) and F-36 (payment of capital-lease obligations $571,000 as of 12/31/1989).

Had all of the proceeds of the Loans been used for the Tender Offer and fees and expenses of the Merger, this case would more closely resemble Panavision and the dissociation of the deduction for the interest on the acquisition debt from the income generated by the target corporation used to pay that interest would not be distortive. However, in the present case, as in Autotote, more than $40 million was used to replace pre-Merger financial obligations of the Partnership and the Operating Companies.[29] This was a significant portion, although not a majority, of the funds. Nothing in the Code, GCT Rules, or other authorities on the distortion requirement for combination establishes or suggests a specific quantitative standard beyond a requirement that the distortion be more than de minimis. *See* Matter of Toys "R" Us-Nytex, Inc., TAT (E) 93-1039 (GC) New York City Tax Appeals Tribunal (January 14, 2004). The GCT Rules make it clear that distortion can exist requiring combination although less that 50 percent of the corporation's receipts or expenses come from intercompany transactions. 19 RCNY §11-91(f)(4).

The Proxy Statement does not identify the specific pre-Merger liabilities refinanced with the Loans. The financial information included in the Proxy Statement shows that as of December 31, 1989, the Partnership and its affiliates had more than $29 million of long-term liabilities and interest expense of almost $4.5 million.[30] T. Ex. 10, at F-21, F-22. For the tax year ending December 31, 1989, the Partnership and its affiliates had a loss of almost $2 million. Thus it appears that without the interest expense, the Partnership and its affiliates would have reported approximately $2.8 million in net earnings. The refinancing of the pre-Merger debt of the Partnership through the Loans effectively shifted that interest deduction

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[29] Petitioners describe the amount of refinanced debt as $60 million. T. Ex. 9. However, that amount appears to include the Subordinated Debentures, which were not refinanced.

[30] As of December, 31 1989, IBK and its affiliates had outstanding long-term debt of about $4 million, excluding the Subordinated Debentures, which were not refinanced in the Merger. Because the pre-Merger financial statements of IBK and its affiliates are consolidated, the Record does not indicate how much of the $4 million debt belonged to ABN or Holographics as opposed to IBK. T. Ex. 10 at F-3, F-4.

from the Operating Companies to the Holding Companies on a hypothetical separate filing basis. We find that shift to be distortive.

Respondent argues that the replacement of pre-Merger debt of the Partnership and the Operating Companies with the Loans in the Holding Companies represented additional purchase price, comparable to a purchaser's assumption of the seller's mortgage on the sale of real property. This argument ignores the fact that the funds used to pay the debt service on the Loans following the Merger came from the Operating Companies not the Holding Companies. Under the mortgage assumption analogy, this would be comparable to the seller continuing to make payments on the mortgage after the sale.

Respondent further argues that the refinancing should be viewed no differently than if the Holding Companies had contributed sufficient funds to the Operating Companies' capital to repay that debt. We disagree. Had the pre-Merger debt of the Partnership and the Operating Companies been repaid rather than refinanced, the overall liabilities of the group would have been reduced and there would be no interest expense shifted from the Operating Companies to the Holding Companies.[31] More significantly, Respondent's argument assumes that the financial and corporate structure of the Merger was a matter of choice; whereas in fact, the structure of the financing for the Merger was dictated by Citibank, which not only required the refinancing of the pre-Merger debt, but imposed other financial restrictions on Petitioners including requiring them to liquidate assets not central to the security printing business to reduce the outstanding amount of the Loans shortly after the Merger. By 1992, Citibank agreed with Petitioners that they needed additional funds to get the US Postal Service contract but Citibank was unwilling to provide the additional funds. USBC ultimately obtained sufficient funds through a public offering in 1992 to refinance the

[31] In any event, such a contribution might represent a flow of value between the Holding Companies and the Operating Companies that would evidence a unitary business.

Loans and to get the contract.

Respondent asserts that the means by which a corporation becomes a member of a group of corporations is irrelevant to a determination as to whether combination is appropriate. We agree. Our conclusion in this case is not that the unitary business and distortion tests for combination were satisfied because the Merger was accomplished using debt rather than equity. Rather, having concluded on this Record that the Merger was essential to the future of the business and resulted in substantial economies of scale for all participants, we find that the consequences of the Merger financing, *e.g.,* the corporate structure and the replacement of pre-Merger debt of the Partnership and the Operating Companies, support the inclusion of the Holding Companies in a combined report with the Operating Companies.[32]

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[32] We do not address in depth Respondent's argument that the fact that the Merger was accounted for as a "purchase" rather than under the "pooling of interests" method of accounting for business combinations supports separate filing by Petitioners. The application of these different methods of accounting, in relevant part, is dictated by the form of consideration received by the parties to the transaction. APB Opinion No. 16 (August 1970), superceded by FASB Statement No. 141 (June 2001). The factors relevant to combined reporting are irrelevant in determining which accounting method should apply. A subsidiary acquired in a transaction accounted for as a "pooling of interests" is no more likely to qualify for combination than one acquired in a transaction accounted for as a "purchase". We have considered all of the other arguments raised by the Parties and find them unpersuasive.

Accordingly, the ALJ Determination is reversed and the Notices are cancelled except to the extent they reflect undisputed Audit adjustments that would apply to Petitioners' combined GCT returns for the Tax Years.

Dated: November 14, 2008
New York, New York

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GLENN NEWMAN
President and Commissioner

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ELLEN E. HOFFMAN
Commissioner