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Tax Departments, Tribunals Differ on Combined Reporting Cases

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The administration of tax disputes in New York State and City is complicated by the fact that each government body not only has its own Tax Department[1], but also its own Tax Appeals Tribunal[2] to adjudicate disputes. As a result, taxpayers who have disputes with both the State and City must often engage in two separate administrative proceedings and litigations. Moreover, tax practitioners analyzing precedents on an issue are often faced with inconsistent authorities. The recent decisions of the New York State Tax Appeals Tribunal in *The Sherwin-Williams Company*, [3]and the New York City Tax Appeals Tribunal in *Toys "R" Us-NYTEX, Inc.*[4], which involve attempts to require combined reporting between so-called Delaware intangible holding companies and related operating companies, illustrate these problems.

Background

A brief background of the legal issues may be useful. Under each of the New York State Corporate Franchise Tax and the New York City General Corporation Tax, corporations file separate tax returns unless they elect and qualify to file a combined return (a method of filing similar but not identical to federal consolidated tax returns). In addition, under certain conditions, the Tax Departments of either the State or the City may require certain related corporations to file on a combined basis. In recent years much of the litigation involving forced combination has involved Delaware corporations which have been set up to hold intangible assets, such as trademarks, and to license them to related operating companies in exchange for royalty payments. Such structures have significant potential state tax benefits because Delaware holding companies are ordinarily exempt from Delaware's corporate tax. Accordingly, if related operating companies doing business in other states are entitled to deduct royalties payable to the Delaware corporation, the overall state tax liability of the group is reduced. Although different states have taken different approaches to prevent the loss of state tax revenue by means of Delaware holding companies,[5] including newly enacted New York legislation in this area,[6] the New York State and City Tax Departments have generally attempted on audit to require combined reporting between the Delaware companies and the operating companies doing business in New York.

Under both the State and City provisions concerning combined reporting, a corporation not otherwise subject to tax in New York may be required to join in a combined return only if combination is necessary to avoid "distortion."[7] For the past 12 years, litigation concerning whether distortion exists has involved an analysis of whether the transactions between the affiliated companies are done at arm's length, using the principles of Internal Revenue Code section 482 and its regulations. Due to the complexity of the issues and the large amounts that are at stake, these cases often involve lengthy trials with numerous reports by accountants, economists and consultants.

The trial in *Sherwin-Williams*, was fairly typical of these cases. The taxpayer had several executives testify that the Delaware companies were not formed to avoid state taxes but rather for valid business purposes. They testified that the corporations were formed to provide oversight and management of the trademarks by avoiding inadvertent terminations and facilitating third party licenses and to ensure that the royalty income was properly invested. They also said that the assignment of the trademarks and related intangible assets to a Delaware holding company could protect the companies from hostile takeovers.

The opinions in *Sherwin-Williams* also describe at great length the economic reports that were prepared to establish that the royalty arrangements were arms' length. American Appraisal Associates prepared the initial study used to determine the fair market value of the intangibles and the appropriate royalty rates, based on sales for each division of the operating companies.[8]

The taxpayer's primary expert at trial was from Grant Thorton who prepared a transfer pricing report and testified as to its findings. The State Tribunal noted that under the tests provided in the section 482 regulations there were four alternative transfer pricing methods: the Comparable Uncontrolled Transaction Method[9], the Comparable Profits Method[10], the Profit Split Method [11] and the Unspecified Method.[12] The Grant Thorton report employed the Comparable Profits Method ("CPM") since it could not identify sufficient comparable licensing transactions to apply the Comparable Profits Method.

Several Criteria Used to Exclude

Much of testimony concerning the report was devoted to the methodology for determining comparable independent companies. [13] Several criteria were used to exclude companies. Initially, in addition to companies for which there was not sufficient reliable data, the report also excluded companies that were not manufacturers, that did not sell to the same market, that did not utilize a similar sales channel and that did not produce similar products. Screening criteria was next used to eliminate startup companies, and to eliminate companies that committed significant resources to research and development or marketing and promotional activities, on the theory that capital invested in R&D and promotion is more risky than capital invested in manufacturing.

The State Tribunal then explained that under the Comparable Profits Method, the arm's-length result is determined by applying the Profit Level Indicators of the comparable independent companies to the financial data of the controlled transactions. The Grant Thorton report concluded that for each of the operating divisions, the average operating profit margin fell within or was slightly higher than the "inter-quartile range"[14] of the comparable companies and, as such, were arm's-length under the section 482 regulations.[15]

The State Tax Department made an extensive presentation to rebut the taxpayer's evidence. The State primarily relied on Dr. Alan Shapiro, a professor at Marshall School of Business at the University of Southern California. Although he did not prepare a separate transfer pricing report, Dr. Shapiro testified at length. The primary focus of his testimony was his determination that there was no economic substance underlying the formation of the Taxpayer's Delaware holding companies and the transfer to them of the trademarks. He testified that the companies did not have the information or experience to manage the intangibles and that only the operating companies had the knowledge of the brands, the customers and the corporate requirements related to brand management. Thus, he concluded, either the Taxpayer would be subjecting itself to economic risks by having the intangibles mismanaged or it would be adding an unnecessary level of corporate bureaucracy. He also testified that the Taxpayer's claims that the separation of the intangibles would aid in a defense against a hostile takeover did not make economic sense since the intangibles were owned by a subsidiary and would be acquired by anyone who acquires the parent corporation.

Pricing Reports Critiques

Dr. Shapiro also made specific critiques of the pricing reports prepared by Taxpayer's experts. He testified that under the profit split method proposed by AAA, the operating companies' earnings would be less than their costs of capital.[16] In his review of the Grant Thorton report, Dr. Shapiro also took issue with the methodology for determining comparable companies, most significantly the exclusion of companies with substantial intangibles. That approach reduced the profitability of the comparable companies by eliminating more profitable ones. Under his analysis, had these corporations not been excluded, the profitability of the operating companies would fall below the relevant interquartile range.

The Tribunal largely accepted the arguments set forth by the Tax Department's expert witnesses and concluded that there was neither a business purpose nor economic substance for the transfer of the intangibles to the Delaware holding companies. The Tribunal noted that the management objectives claimed by the Taxpayer "were unattainable or outright illogical," and pointed out that the person hired to run the Delaware holding companies was a part-time employee who was, at the same time, "employed as a full professor, owner of his own consulting firm and director of several other corporations."

The Tribunal also agreed that Grant Thornton's method of selecting comparable companies for purposes of the Comparable Profits Method improperly excluded high-profit companies because they had significant intangibles. Finding both an absence of business purpose/economic substance and improper transfer prices, the State Tribunal concluded that the Taxpayer was required to report with its New York affiliates on a combined basis.

City Tribunal in 'Toys "R" Us'

The City Tribunal decision in *Toys "R" Us* reveals a markedly different approach to this type of litigation by the City Finance Department. The *Toys "R" Us* case involved the trademarks for the toy chain and its clothing affiliate, Kids "R" Us, which in 1984 were contributed by the parent corporation to a Delaware holding company, Geoffrey, Inc.[17] The case presented by the Taxpayer at trial was quite similar to the case presented by *Sherwin-Williams*.[18] The Taxpayer introduced similar testimony concerning its business purposes for transferring the trademarks and other intangibles to Geoffrey, noting that, before the transfer, the parent corporation "was not particularly diligent in trademark protection and some infringements were not addressed." The Taxpayer also put in testimony that the Delaware holding companies were formed to protect the companies from hostile takeovers.

The Taxpayer also put into evidence pricing studies prepared by Arthur D. Little, Inc. and Ernst & Young, LLP, using a rate of return analysis and a Comparable Profits Method analysis similar to the one prepared for *Sherwin-Williams*. Both reports found that the profitability of the operating companies came within the applicable inter-quartile range and, therefore, the licenses were arm's length transactions using the applicable Code section 482 standards.

At the trial before the Administrative Law Judge,[19] however, the City Finance Department in *Toys "R" Us* did not attempt to rebut the transfer pricing studies of the Taxpayer and its experts as the State had done in *Sherwin-Williams*. In fact, the City did not present any expert testimony to challenge the methodology of the pricing studies, or the taxpayer's testimony concerning the business purpose for the initial transfers of the intangible assets to the Delaware holding companies. The only witness put on by the City was its tax auditor who simply testified to audit activities not in controversy. The City's approach was to argue that the 1984 transactions "should be considered together as integrated transfers-licensebacks and disregarded as separate transactions for GCT purposes. Respondent asserts that since, for tax purposes, no transfers took place, Petitioner's income was not properly reflected regardless of whether the subsequent Tax Years' intercompany transactions were at arm's length…." The ALJ rejected the City's argument concluding that the 1984 transactions may not be disregarded.

On appeal to the City Tax Tribunal, the City reiterated its position that, regardless of whether the royalty rate was arm's length under the section 482 regulations, the initial transfers of the intangibles to the Delaware holding companies were not *bona fide*, and therefore any royalties paid by the operating companies were *per se* distortive. The City Tribunal noted that "Respondent asserts that the 'royalties' paid by Toys, Inc. to Geoffrey are nondeductible capital contributions [and] the deduction of the royalties and interest" necessarily produced distortion.

In response, the City Tribunal noted that the City's theory on appeal would require the correction of 49 of the ALJ's 80 Findings of Fact, and that many of the Findings, including those relating to the initial transactions, were contained in the Stipulation filed with the ALJ. The City Tribunal noted that the Tribunal Rules[20] treat a stipulation as a "conclusive admission by the parties." It went on to express its frustration that the City failed to acknowledge that the findings it requested were contrary to the Stipulation. The Tribunal said: "Respondent has not specifically argued that the Stipulation is contrary to the evidence in the record and has not offered this Tribunal any guidance as to how to deal with this troubling issue."

At the end of its opinion, the City Tribunal discussed the earlier State Tax Tribunal decision in *Sherwin-Williams* and distinguished it by noting that the State Tribunal found that the transfer of the intangibles in that case did not have a valid business purpose and also found that that the royalty rates were not at arm's length.

Speculation

Since the City Tribunal is required to treat decisions of the State Tribunal as binding precedent,[21] one may speculate that the City could have prevailed in *Toys "R" Us* had it prepared its case in the same manner as the State did in *Sherwin-Williams*. As noted above, the issue in these cases has been rendered moot by subsequent legislation. Nevertheless, the fact that different approaches to the litigation of similar cases by the two Tax Departments likely resulted in inconsistent decisions by the two Tax Tribunals has relevance to New York tax practitioners in a number of areas where the two authorities overlap.

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1 The New York State Department of Taxation and Finance and the New York City Finance Department.

2 Each Tribunal consists of an Administrative Law Judge level that conducts hearings and a three judge panel that hears appeals from determinations by the Administrative Law Judges.

3 DTA 8016712 (June 5, 2003).

4 TAT(E) 93-1039 (GC), January 14, 2004.

5 For example, in *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15 (1993), the South Carolina Supreme Court found that Geoffrey had sufficient nexus to that state through the presence of intangible property so that the tax imposed did not violate the United States Constitution.

6 In 2003, the New York State legislature enacted Tax Law section 208(9)(o) and NYC Admin. Code section 11-602(8)(n) requiring that royalties paid to related persons be added back for Corporate Franchise Tax and General Corporation Tax purposes.

7 NYS Tax Law section 211(4), NYC Administrative Code section 11-605.4. In addition to the requirements of distortion, the corporations must satisfy a stock ownership test and a unitary business test. 20 NYCRR 6-2.2(a) and (b) (State); 19 RCNY sections 11-91(a) and (e) (City).

8 The divisions and the applicable royalty rates were: Stores Products 2.5%, Consumer Products 2.5%, Chemical Coatings 1%, Automotive Products 4.5% and Specialty Brands 4%.

9 Reg. section 1.482-4(c)(1). This method evaluates whether a transfer is at arm's length by reference to the amount charged in comparable transactions between unrelated parties.

10 Reg. section 1.482-5(a). This method evaluates whether the amount charged in a controlled transaction is arm's length by reference to profit level indicators derived from unrelated parties engaged in similar activities.

11 Reg. section 1.482-6(a). This method makes the arm's length evaluation by reference to the relative value of each controlled party's contribution to the combined operating profit.

12 Reg. section 1.482-4(d). This method, which is less specific, is only usable if none of the other alternatives can be used.

13 Since the taxpayer operated under five separate divisions, this analysis was done for each division separately.

14 The Tribunal explained that the inter-quartile range is defined to encompass the middle 50 percent of the results of the uncontrolled companies, i.e. between the 25th and 75th percentile, and is considered adequate for section 482 purposes. (Treas. Reg. section 1.482-1(e)(2)(iii)(B)).

[15] A third somewhat different report for the taxpayer also concluded that the rates were arm's-length.

[16] The AAA report applied a 25-33% profit split to net profit. Dr. Shapiro argued that a split should only apply to residual profit, (after subtracting the weighted average cost of capital).

[17] The trademarks include the symbol for Geoffrey the giraffe, hence the name. The case also involved other Delaware companies which provided financing to the operating companies.

[18] The similarity results, in part, from the fact that Morrison and Foerster, L.L.P. represented both taxpayers.

[19] TAT(H)93-1039(GC) August 4, 1999.

[20] 20 RCNY section 1-09(a) and (e).

[21] New York City Charter, section 170(d). *See*, *U.S.Trust Corporation and Subsidiaries* TAT (E) 93-204, 93-205 and 93-804 (BT) (City Tax Tribunal) for a case where the City was bound by possible litigation failures on the part of the State Tax Department.