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Combined Reporting: The Sherwin-Williams Case

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The latest news from the New York State and City Tax Appeals Tribunals is that, for the first time in quite a while, we have fully staffed State and City appellate panels. With the Mayor's appointment of Kalman Finkel, the City Tax Appeals Tribunal is now at its full compliment. Mr. Finkel joins Arthur A. Strauss who was appointed by Mayor Giuliani this past spring and Mark Friedlander, the President and an original member of the City Tax Appeals Tribunal. The State Tax Appeals Tribunal has had its full three-person appellate panel in place since December 1996 after a period from July through December 1996 when the Tribunal was without its full compliment of Commissioners.

The biggest case to come out of the New York State Division of Tax Appeals recently (both in impact and in length) is the *Matter of Sherwin-Williams Company*.[1] That determination contained 392 findings of fact and 32 conclusions of law in 66 pages finding that two Delaware subsidiaries holding the rights to the trademarks, trade names and service marks of the well-known paint manufacturer did not have to be included in the combined report with its parent corporation.

Combined Reporting

As discussed in previous articles, in order for a corporation to be permitted or required to be included in a combined report for the New York corporate tax, the company must have 80% or more common ownership,[2] be engaged in a unitary business[3] and if "reporting on a separate basis distorts the activities, business, income or capital in New York of the taxpayers."[4] That Regulation continues stating, "[t]he activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations." There was no dispute about the stock ownership or unitary business requirements. The entire case was based upon the distortion test.

Setting up the Delaware Trademark Companies

The basic facts were not in dispute. Sherwin-Williams ("Taxpayer") had been in business since 1884. In 1991, two subsidiaries (SWIMC, Inc. and DIMC, Inc.) were formed under the laws of Delaware. As part of a Federal tax-free reorganization under IRC Search7RH351, the trademarks, trade names and service marks (collectively, "Marks") were transferred to the two Delaware subsidiaries. On the next day, Sherwin-Williams received a license from the two Delaware subsidiaries to use the Marks and agreed to pay royalties for such use. In addition, there were intercompany loans from one of the Delaware subsidiaries to the parent corporation and there was a charge for trademark services performed by Sherwin-Williams for the benefit of the two Delaware subsidiaries.

The Department argued that the purpose of forming the Delaware subsidiaries was to avoid or minimize state taxes. In support of this, the Department presented evidence of the role of members of the Sherwin-Williams tax department in planning the project and pointed to advertising brochures of promoters of the transaction. The ALJ rejected this argument stating that taxpayers are free to structure their business affairs as they choose, including structures to minimize state taxes. She also noted that many of the articles publicizing the advantages of Delaware trademark companies were written after Sherwin-Williams' subsidiaries were formed.

Intercompany Transactions

Looking at the particulars of this matter, the first interesting aspect involves the presumption of distortion when there are substantial intercompany transactions (defined as more than 50%).[5] The question has always been raised: From which perspective is this judged, the parent's or the subsidiary's? In the *Sherwin-Williams* case, from the parent corporation's perspective, the intercompany transactions with the two trademark companies were quite small. The ALJ rejected that point of view, without citing any precedent, stating that the two subsidiaries received the vast majority of their royalty income from the parent corporation and that gave rise to the (rebuttable) presumption of distortion.

Notwithstanding the presumption of distortion, the taxpayer was able to demonstrate that: (1) the transactions had a valid business purpose; (2) the transactions had economic substance; and (3) there was arm's-length pricing of the royalty payments, the interest rates on the intercompany loans and the charges for trademark services performed by the parent corporation for the benefit of the subsidiaries. Consequently, the ALJ found that the Delaware subsidiaries were not required to be included in the Taxpayer's combined report since the presumption of distortion had been rebutted.

The extensive discussions of the arm's-length pricing and the various expert witnesses called to testify about the transactions filled dozens of pages of the Determination.

The Taxpayer called a witness to testify about the study originally used to arrive at the value of the Marks and the royalty rates for use of the Marks in 1991. The Taxpayer also called an attorney specializing in trademark and intellectual property law who had been involved in the formation of the Delaware subsidiaries in 1991. He testified that having the Delaware subsidiaries hold the Marks provides substantial benefits from a trademark law perspective. On the quantitative issues, the Taxpayer had expert testimony (and written reports) from a large accounting firm that performed a transfer pricing study applying Internal Revenue Code Search7RH482 principles to the three intercompany transactions at issue (royalty rates, interest on loans and charges for servicing). The Taxpayer also had another well-known tax practitioner and accountant analyze the tax returns and demonstrate that the tax New York was claiming under combined reporting was 550% what would be owed under separate accounting principles. The Taxpayer also called a professor of law specializing in State and local taxation to testify about the policy issues behind New York's law on combined reports concluding that requiring a combined report in this case was inappropriate and, in view of a separate accounting analysis, unconstitutional.

The Tax Department called two expert witnesses on its behalf. One a trademark and intellectual property lawyer who testified that the transfer of the Marks did not result in any benefits as a matter of trademark law, practice or strategy and that there were simpler and more efficient ways to achieve the benefits outlined by the Taxpayer. The Department also had an expert critique the valuation done in 1991, the transfer pricing study and the separate accounting analysis. This expert found flaws in each of the Taxpayer's expert testimony and the reports issued.

In the end this "battle of the experts" was won by the Taxpayer. The easiest issue was the interest rates charged on the intercompany loans which, since they were the same rates as charged by an unaffiliated lender, were found to be arm's-length. Next, the charges for trademark services were also found to be within the range of rates charged by independent legal practitioners for the performance of such services in the geographic area. The ALJ also found the royalty rates to be reasonably arm's-length but for one flaw (the report failed to annualize the eleven months of actual royalties) that was held to be *de minimis*. However, the ALJ rejected one of the Taxpayer's expert's opinion on IRC Search7RH482. She also found that the separate accounting analysis provided little support to the Taxpayer's position and failed to adequately address inconsistencies raised by the Department.

What Can We Learn from This?

Attempting to draw lessons from this case is not easy. The first lesson is, notwithstanding the Audit Division's statements to the contrary, not every Delaware subsidiary of a New York corporate taxpayer can be required to be included in a combined report. As in this case, establishing a business purpose, respecting the corporate form and paying arm's length prices can preclude having an affiliate dragged into a combined report.

All of those acts, however, cannot protect taxpayers from incurring the tremendous cost of contesting such an audit. There was also a significant cost in time and money to the State in pursuing this audit including incurring the expense of hiring experts to analyze the taxpayer's expert reports and testify. And, its not over yet; the State has filed an exception to the ALJ Determination so this matter will be heard by the appellate body of the State Tax Appeals Tribunal.

As anyone who reads the entire *Sherwin-Williams* case can see, the litigation was torturous including ugly skirmishes over claims of privilege and compliance (or lack thereof) with discovery. When faced with similar expensive and drawn-out audits and protests in IRC Search7RH482 cases (mostly in the context of transactions with foreign affiliates), the IRS instituted a program using Advanced Pricing Agreements so that taxpayers could meet with the agency and come to agreement on the pricing of intercompany transactions. Under such a program, both sides have an opportunity to come to an agreement and save the time and expense of litigation. Presumably, the taxpayer will show the tax agency its books and records on how it arrived at the pricing of the intercompany transactions, permit the tax agency to review the arrangements and satisfy itself that the transactions are at arm's length prices. If not, discussions may be had to arrive at agreed upon adjustments to reflect proper pricing. Once such an agreement has been reached, periodic reviews can be scheduled and both the taxpayer and the tax agency would be confident that corporate tax returns would be filed that accurately reflect the business, income and activities within New York including only those affiliates agreed upon.

This example seems like an approach worth pursuing by the State and City tax departments as means to reduce costly, time-consuming and contentious litigation in this area.

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[1] ALJ Determination, decided June 7, 2001.

[2] 20 NYCRR 6-2.2(a).

[3] 20 NYCRR 6-2.2(b).
[4] 20 NYCRR 6-2.3.
[5] 20 NYCRR 6-2.3(c).