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State Challenges to Related Party Transactions

D. French Slaughter III

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D. French Slaughter
Deloitte & Touche LLP
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State Tax Planning Using Related Party Transactions Under the Microscope

I. Related Party Transactions – Respected By the Courts


1. **Facts.** Sonat was a holding company that owned Sonat Offshore Drilling ("SODI"). SODI paid substantial dividends to Sonat, which is taxable in Alabama.

   Alabama law permits a deduction for dividends received from certain affiliated corporations that are taxable by Alabama. For Sonat to take advantage of this deduction, it was necessary for SODI to be taxable by Alabama. Apparently for this reason, SODI leased a single workstation to a wholly owned subsidiary of Sonat for use by that subsidiary in its Birmingham office. *The monthly rent was $145.*

   In 1988, SODI paid a dividend of $185 million to Sonat, which Sonat deducted on the grounds that SODI was subject to Alabama tax on the income it received from leasing the workstation.

2. **State Attack.** The Alabama Department of Revenue rejected Sonat’s deduction of the dividend on the grounds that the lease between SODI and a related corporation was entered into in order that Sonat could avoid paying taxes on the dividends received from SODI. If the lease were not respected, SODI would have no Alabama taxable income and the dividend to Sonat would be taxable in full. The Department characterized the lease as a sham, having no practical economic effect other than to create an income tax benefit.

3. **Holding.** The Alabama Supreme Court rejected the Department’s position. The court agreed with the Department “that it seems likely that the primary, if not the sole, purpose of the [lease] was to qualify Sonat for the dividends received deduction. Even if this were the sole purpose of the lease, that does not make it a ‘sham’ nor does it mean that the transaction should be disregarded. The court finds whatever the motivation, the lease was ‘real,’ the workstation was located in Alabama, and the rent was paid.”
B. The Maryland Cases.

1. **Taxpayer Wins.** On March 17, 2000, the Maryland Circuit Court for Baltimore City affirmed the decisions of the Maryland Tax Court in SYL, Inc. v. Comptroller, MCI International Telecommunications Corp v. Comptroller, and Crown Cork & Seal (Delaware) Inc. v. Comptroller that attributional nexus is limited to "phantom" entities under Maryland law. The court concluded that the companies at issue were not "phantom" or "sham" corporations since they had economic substance and were established for valid business purposes, including the protection of valuable intellectual property rights.


(a). **Facts.** MCI International Telecommunications ("Taxpayer") is a wholesaler of international telecommunications services. It is part of an affiliated group of corporations. The parent of the affiliated group is MCI Communications, which has two subsidiaries: MCI Telecommunications, which operates throughout the U.S., including Maryland, and MCI International, which provides international telecommunications. MCI International is the parent of Taxpayer.

Taxpayer provides international voice service to its customers. Its existence was mandated by the need to a single entity operating in an environment heavily regulated by the federal government. In addition, the Taxpayer, was a completely different type of business than the domestic voice transmission business.

Taxpayer provides international telephone service to foreign telephone companies and domestic long-distance telephone companies in exchange for service fees. An international telephone call completed by Taxpayer starts at a mainland point. If it is an inbound call to the United States, the call typically originates with the customer of a foreign telephone company. The foreign company bills its customers and pays Taxpayer a service fee. At the midpoint on the ocean cable, Taxpayer picks up the call and transmits it to a cable head where the ocean cable reaches the shoreline. Taxpayer pays a service fee to its parent, MCI International, for the capacity to carry calls on the cable. Taxpayer then carries the call to a gateway switch. Taxpayer terminates the call at the gateway switch. Taxpayer pays a domestic long distance carrier a service fee for carrying the call.

An outbound call operated in reverse fashion. A domestic long distance carrier sends the call to its gateway switch, where Taxpayer picks it up and transfers it at the ocean midpoint to the foreign telephone company, which completes the call on the foreign side of the transaction. The domestic long distance carrier pays Taxpayer a fee for its service in completing the international call. Taxpayer would pay the foreign telephone company a fee for taking its call and completing it. MCI Telecommunications paid Taxpayer $56 million in service fees.
(b). **State Attack.** Taxpayer has no nexus with Maryland but MCI Telecommunications does. The Comptroller treated Taxpayer as having nexus because of the nexus of its affiliate, MCI Telecommunications. The Comptroller also used Telecommunication's factors for apportioning the income of Taxpayer, which did not have any Maryland factors. Essentially the Comptroller determined that the Taxpayer existed solely to allow MCI Telecommunications to divert income out of Maryland.

(c). **Holding.** The circuit court upheld the decision for the Taxpayer by the Maryland Tax Court. The Tax Court held that Taxpayer did not have nexus with Maryland and that it was an operating company. Accordingly, the only theory by which the comptroller could levy a tax was if the Taxpayer was a phantom corporation within the meaning of *Armco Expert*, 82 Md.App. 429 (1990) and *Comptroller of the Treasury v. Atlantic Supply Co.*, 294 Md. 213 (1982). The Tax Court held that Taxpayer was not a phantom corporation and had economic substance. Taxpayer performed business activities, generated income from non-affiliated entities, had substantial property on its books, and had employees. Further even if Taxpayer had nexus with Maryland, the comptroller would be required to use the Taxpayer's apportionment factors and not that of MCI International.

3. **SYL Inc. v. Comptroller** (Md. Cir. Ct., No. 24-C-99-002389) and **Crown Cork and Seal Inc. v. Comptroller** (Md. Cir. Ct., No. 24-C-99-002388).

(a). **Facts.** These cases both involved Delaware trademark and protection companies, which were formed to hold the former trademarks of their parents. The Delaware subsidiaries then licensed back the trademarks to their parents in exchange for a royalty. Maryland is a separate entity state so that the payment of royalties by the parents, which had nexus with Maryland, reduced their Maryland income tax.

(b). **State Attack.** The Comptroller treated the subsidiaries as if they were "phantom" corporations.

(c). **Holding.** The circuit court upheld the Tax Court’s rejection of the Comptroller’s approach. The Tax Court relied on *MCI International*, concluding that SYL and Crown had economic substance, were non-phantom corporations, and did not have substantial nexus with Maryland. The subsidiaries maintained Delaware bank accounts, received mail in Delaware, and maintained offices in Delaware. They were established for valid nontax reasons, such as protecting the transferred intangibles from the claims of their parents’ creditors, improving the management of the intellectual property, and protecting the property from a hostile takeover. *The Tax Court stated that tax avoidance (rather than tax evasion) was a legitimate business purpose.*

(a). **Facts.** Gannett is a Delaware corporation, headquartered in Virginia. Gannett has nexus with Maryland. Gannett maintains centralized company accounts for its subsidiaries. The subsidiaries deposit proceeds in these accounts and draw them out to pay expenses. If a subsidiary deposits more than it withdraws, the excess does not accrue interest. If a subsidiary withdraws more than it deposits, no interest is charged on the deficit. The parties stipulated that this arrangement created interest free debt.

Gannett filed a consolidated federal tax return in which the intercompany loans washed out. Gannett did not report the intercompany loans on its Maryland return. Maryland does not allow related corporations to file consolidated returns.

(b). **State Attack.** The Comptroller sought to impute interest income to Gannett from the interest free loans it made to its subsidiaries. The comptroller relied on Sections 482 and 7872 of the Internal Revenue Code.

(c). **Holding.** The Court of Appeals, Maryland’s highest court, held that the state legislature has not authorized the comptroller to exercise power under I.R.C. Section 482. If the IRS fails to exercise its discretion under Section 482, the comptroller must accept the resulting federal income.

With respect to Section 7872, the court held that while this provision is mandatory at the federal level and not discretionary, the Comptroller is required to administer it pursuant to IRS interpretations. The regulations provide that in the case of a consolidated return, the failure to impute income has no federal effect. Accordingly, Gannett as not required to impute interest on its federal return. Its federal taxable income was correctly determined and the Comptroller must accept those figures.

C. **In the Matter of Petition of Toys R Us-NYTEX, Inc, TAT(H) 93-1039 (GC), August 4, 1999, 1999 NY City Tax Lexis 31.**

1. **State Attack.** New York attempted to impose a combined report on certain members of the Toys R Us family. The City argued that substantial intercorporate transactions were not made on an arm’s length basis or must be disregarded. The statute permits the City to impose a combined report on related corporations if it is necessary to properly reflect income and tax liability. More specifically, a combined filing may be required if: there is common ownership among the corporations to be combined; the corporations are engaged in a unitary business; and filing on a separate basis would distort a corporation’s income.

Regulations issued by the City establish a presumption of distortion where there are substantial intercorporate transactions between members of a related group. “Substantial” is defined as that circumstance where as little as 50% of a
corporation's receipts or expenses are from one or more qualified activities. To overcome this presumption of distortion, the taxpayer must establish that the transactions were carried on at arm's length.

2. **Holding.** The Administrative Law Judge rejected the City's position. It found that the Taxpayer established that the royalty rate that was paid to Geoffrey for the use of the Toys R Us trademarks occurred at an arm's length rate.

3. **Interest Charged At Less Than Arm's Length Not Relevant.** Geoffrey lent some of the royalties it received from affiliated corporations to others in the corporate family. The judge found that some of the intercorporate loans did not occur at an arm's length rate of interest. However, in this case the lack of an arm's length rate of interest actually favored the City. Had an arm's length interest rate been charged, the amount of income reported by those corporations doing business in the City would have been even less. *Consequently, the lack of an arm's length interest rate could not justify the imposition of a combined report.*

4. **State Attacks Again.** In the middle of the formal hearing, the City changed its theory of the case and argued that combination was appropriate because the transfer of the trademarks to Geoffrey and the licensing by Geoffrey to affiliated corporations lacked economic substance.

5. **Taxpayer Wins (Again).** The ALJ determined that Geoffrey was created for several valid business purposes, including but not limited to, owning and protecting the existing Toys R Us trademarks; establishing and registering new trademarks; licensing those trademarks, and defending the integrity of the trademarks in litigation. It was anticipated that Geoffrey would realize a profit from its licensing activities, apart from any tax benefit and that Geoffrey did realize such a profit. The ALJ concluded that Geoffrey was established for valid business purposes, was characterized by economic substance, and was not motivated solely by tax avoidance.


1. **Facts.** JC Penney National Bank (Taxpayer) is a federally chartered national banking association incorporated and headquartered in Delaware. The Taxpayer issues Visa and MasterCard credit cards, and offers consumer banking services such as deposit accounts, home mortgages lending, general consumer loans, and ATM services.

   The Taxpayer is a subsidiary of the JC Penney Company ("Parent"). The Parent owns and operates retail stores in Tennessee. Taxpayer contracts with Parent for the provision of various marketing and processing services such as deposit accounts, home mortgages lending, general consumer loans, and ATM services.
Taxpayer had no office, place of business or employees in Tennessee. Taxpayer solicited Tennessee residents using the U.S. mail. Other than that, all activities were provided Taxpayer by its Parent or those persons with whom Parent subcontracted.

2. **State Attack.** The Tennessee Department of Revenue assessed franchise and excise tax against the Taxpayer on income derived from its credit card services. The Chancery Court (the trial court) upheld the assessment.

3. **Holdings.** The Appeals Court held that Due Process nexus existed. Through its solicitation of Tennessee customers, the Taxpayer “purposely availed itself of the substantial privilege of doing business in the State,” so that sufficient “minimum contacts” existed.

   However, the Appeals Court held that no Commerce Clause nexus existed. The Court read *Quill* as requiring a physical presence nexus standard, notwithstanding that the assessment at issue was for the State’s franchise or excise tax. “While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.”

4. **Physical Presence of Credit Cards Disregarded.** The Court rejected the State’s argument that the Taxpayer satisfied the physical presence standard because it owned the credit cards that cardholders carried with them in Tennessee. The court agreed with the Commissioner that the cards were tangible property but did not agree that their presence in Tennessee was constitutionally significant. The court felt that the cards were virtually worthless and not sufficiently significant to satisfy the substantial nexus requirement of the Commerce Clause. The real value of the cards were in the intangible rights they represented. “The actual card is not even necessary to the transaction. It merely serves as a convenient article on which to record the necessary information regarding the customer’s account.”

5. **Retail Stores.** The Court also held that the Parent’s stores did not give the Taxpayer a physical presence in Tennessee. The Parent’s stores were not affiliated with the Taxpayer’s credit card operations. The Court noted specifically that the stores did not accept applications or payments for the credit cards. “The retail stores conducted no activities which assisted the [Taxpayer] in maintaining its credit card business in Tennessee. The record shows that one could not apply for the [Taxpayer’s] credit cards at the J.C. Penney retail stores, nor could individuals make a payment on their...account at the retail stores.”

6. **Agency Nexus.** Finally, the Court rejected the State’s argument that the Taxpayer had a physical presence through the activities of those persons acting on its behalf, citing *Tyler Pipe* and *Scripto*. The Court described those cases as
situations in which the taxpayers had physical presence through the activities of their independent contractors in the taxing state. Here, however, none of the persons providing services on behalf of Taxpayer did so in Tennessee.

Accordingly, the Court reversed the holding of the Chancery Court. On May 8, 2000, the Tennessee Supreme Court declined to hear an appeal from the lower court decision.

7. **Cert Denied.** Was the Supreme Court tempted to visit “economic nexus” as a proper test and limit Quill to sales and use tax?


1. **Facts.** Bandag Licensing Corp. (“BLC”) owned three patents that it licensed to Bandag, its parent, under a 1985 agreement executed outside Texas. Royalty payments were mailed to BLC’s Iowa office; no payments were received in Texas. BLC did not own, possess, use, or maintain any real or tangible personal property in Texas. It did not have salespeople, employees, independent contractors, or any other type of representatives in Texas, nor did it send any such persons into Texas. BLC did not have franchises in Texas, did not distribute goods or services in Texas under a marketing plan or system prescribed in substantial part by Bandag, and did not transact any intrastate business in Texas. However, BLC did possess a Texas certificate of authority throughout the audit period.

2. **State Attack.** The Texas Comptroller assessed franchise tax on BLC solely because BLC held a certificate of authority.

3. **Holding.** The court examined the assessment on this basis under the Due Process and Commerce Clauses. Under the Commerce Clause, the court used the four-pronged test under *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1997), to derive two questions – is there an “activity” and is there “substantial nexus?” Because the possession of a certificate of authority is passive, the court held that there was no activity.

Then the court examined the term “substantial nexus,” and found that the physical presence test declared in *Quill* and *Bellas Hess* applied to Texas franchise tax as well. The court then concluded that when a corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.

4. **Due Process Lives!** The court also examined whether the imposition of the Texas franchise tax would offend the Due Process Clause. Because the passive possession of a certificate of authority would be insufficient for purposes of
personal jurisdiction under state law, the court concluded that it is insufficient for purposes of imposing the Texas franchise tax.

5. **Economic Nexus Denied Too.** The court then turned its attention to the issue of whether the receipts from intangible property created nexus. On appeal to the court, the Comptroller raised for the first time the contention that the royalty payments received by BLC were, by themselves, or in conjunction with BLC’s certificate of authority, sufficient to satisfy the substantial nexus test. The court held that the Comptroller raised this issue too late and had waived its right to complain of this error. While this type of decision invites another challenge by the Comptroller, the court indicated that even if the royalty payments were from the parent’s use of patents in Texas, the facts found by the district court did not support a finding of substantial nexus.

**II. Related Party Transactions - Not Respected By the Courts**


1. **Facts.** Geoffrey, Inc., a wholly owned subsidiary of ToysRUs, Inc., was incorporated in Delaware with its principal offices located in that state. It had no employees, offices or physical property located in South Carolina. The Delaware holding company owned several trademarks and trade names, including “ToysRUs.” Under a license agreement, ToysRUs agreed to pay Geoffrey 1% of net sales for the right to use the ToysRUs trade name and other trademarks and trade names in connection with the sale of children’s goods in most states. The trademark was displayed on the six ToysRUs retail stores located in South Carolina as well as on merchandise and in advertisements.

2. **State Attack.** The South Carolina Supreme Court held that “licensing intangibles for use in South Carolina and receiving income in exchange for their use” created sufficient nexus with state to meet both the “minimum connection” standard required by the Due Process Clause and the “substantial nexus” requirement of the Commerce Clause. The court further found that Geoffrey had intangible properties – a franchise (license of a trademark and a trade name) and accounts receivable generated by sales – in the state, the presence of which also satisfied the “minimum connection” due process requirement. Thus the state could properly impose state corporate income and license tax on this out of state affiliate of the in-state stores.

3. **Cascading Impact.** The decision of the South Carolina Supreme Court has encouraged several stated to increase their efforts to tax out-of-state corporations, particularly passive investment companies, that do not have a physical presence in the state. Since the U.S. Supreme Court denied *certiorari* in this case, the decision in *Geoffrey* is law only in the State of South Carolina. However, a
number of states are using Geoffrey-type reasoning to bolster expansion of their income tax nexus regulations to include economic presence tests.

The following chart reflects the known positions of states that have formally or informally adopted the "Geoffrey nexus" position by statute, rule or regulation, or informal audit position:

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<th>State</th>
<th>Statute</th>
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"F/S" – Financial Services  
"PICs" – Passive Investment Companies, Intangible/Intellectual Property Holding Companies, etc.


1. Facts. The taxpayer maintained a Delaware-based trademark holding company.
2. **State Attack.** The Department focused on the initial transfer of trademarks to the Delaware holding company and argued that an intercorporate transfer pursuant to Internal Revenue Code Section 351 (i.e., a nontaxable exchange of property for stock) *always* results in a distortive arrangement between the related parties.

3. **Holding.** The administrative law judge concluded that while an initial transfer pursuant to I.R.C. Section 351 does not *always* result in a distortive arrangement, the splitting of income and the ongoing expenses related to the maintenance of the income-producing asset did result in distortion of the taxpayer’s income in this instance. The ALJ further determined that there was “little or no economic or business justification for the formation of “ the trademark affiliate and that New York tax avoidance was the principal purpose behind its formation. Little or no expenses were incurred by the subsidiary and no real nexus was created by the subsidiary in Delaware. The ALJ required the two entities to file a New York combined return.


1. **Facts.** Tropicana sales subsidiary forced to file New York combined return with its out-of-state parent and feed producing affiliate. Tropicana submitted into evidence an IRC §482 transfer pricing report prepared in preparation for the litigation to illustrate that sales of products between the Florida parent and subsidiaries were at arm's length.

2. **State Attack.** New York attacked the structure arguing that the omission of the Florida entities from the New York return distorted the subsidiary’s New York income and that the taxpayer could not rebut the presumption of distortion because the intercompany pricing was not arm’s length.

3. **Holding.** The ALJ ruled that the transfer pricing analysis “failed to prove that charges to [the Tropicana subsidiaries] for services, equipment and use of facilities provided by [the Tropicana parent] were consistent with what would have been charged by Tropicana if it had been dealing at arm’s length with an uncontrolled party.” The transfer pricing study employed the comparable profit method (CPM) to determine intercompany charges for products and services. In his ruling, the ALJ criticized the selection of several companies as comparable companies in Tropicana’s Section 482 analysis on the ground that they lacked “financial/sales comparability.”

4. **Refund Sought.** The outcome may have been influenced by the fact that the taxpayer had previously been filing combined with its out-of-state parent in New York and sought to break combination only when New York sought to combine the Florida-based feed producing affiliate as well.

1. **Facts.** Overnite Transportation (Taxpayer) was acquired by Union Pacific for $1.2 billion. Union Pacific subsequently created a holding company, Overnite Holding. Union Pacific contributed its Overnite stock to Overnite Holding. Overnite declared a dividend in the form of a $600 million promissory note to Overnite Holding, payable in full in ten years. Overnite deducted the interest on the note.

2. **State Attack.** The Department of Revenue denied the interest deduction because it determined that there was no true debt for tax purposes. The note carried an interest rate that was below market levels and which did not reflect the foreseeable risk attendant on assumptions that Overnite earnings would grow indefinitely at projected robust levels. Overnite also continually failed to pay interest when due. This ongoing default made any expectation of repayment of the note unrealistic. The note was treated even by the parties as equity and not as debt.

3. **Holding.** The Board of Tax Appeals upheld the Department.

E. In the Matter of Kmart Properties, NM ID. No. 01-287446-00 6, Before the Hearing Officer of the Taxation and Revenue Department of the State of New Mexico. (Feb. 1, 2000).

1. **Facts.** Kmart Properties (Taxpayer) is a wholly-owned subsidiary of Kmart Corporation (Parent). Parent’s headquarters, principal place of business, and commercial domicile are in Michigan. Taxpayer is organized as a Michigan Realty and Investment Company. Taxpayer has its own offices separate from that of its Parent and had two staff attorneys, a paralegal, and a legal secretary, some of whom transferred from Parent. Taxpayer owns all of Parent’s domestic service marks, trademarks, and trade names. Taxpayer granted an exclusive license to Parent for the use of this intellectual property in return for a 1.1% royalty of the Parent’s net sales. The royalties received by Taxpayer were lent back to Parent, usually within two or three days from when they were received. None of the loans was ever repaid.

2. **Holding.** The Hearing Officer of the Taxation and Revenue Department (Hearing Officer) upheld an assessment for the gross receipts tax and income tax. The income tax assessment was based on a single factor sales formula. According to the Hearing Officer, the creation of Taxpayer originated in the Kmart Tax Department, not its Legal Department. The non-tax reasons for creating the Taxpayer, i.e., providing greater focus, responsibility and accountability for management of Kmart’s intellectual property, could have been achieved by
forming a separate division within Parent. The Hearing Officer found that the real reason for the formation of Taxpayer was to reduce Parent's corporate income taxes in states that allow separate entity filing.

The Hearing Officer concluded that the Taxpayer had due process nexus with New Mexico. The Taxpayer “has purposefully availed itself of the benefits of an economic market within New Mexico. [Taxpayer] owns highly valuable intangible property ... which it has licensed for use by [Parent] within New Mexico.”

The Hearing Officer next determined that Quill's “substantial nexus” test applied to income and excise taxes. “I can find no principled basis to distinguish between sales and use taxes, and income taxes under the Commerce Clause. The Taxpayer satisfied this test through its contractual relationship with its Parent under the license agreement. Under that agreement, Parent uses the trademarks as a marketing tool to continuously solicit New Mexico residents to purchase merchandise that creates the income stream that New Mexico seeks to tax. The Parent’s relationship to Taxpayer, “particularly in light of the requirements of trademark law which render the trademarks inseparable from the goodwill of the business they are associated with, places [Parent] in the same position as the salesmen in Scripto and the independent salesmen in Tyler Pipe. [Parent] is contractually obligated to do the very things which establish, maintain, and enhance the market for [Taxpayer’s] trademarks in New Mexico in order to generate a revenue stream for [Taxpayer] derived from those marketing activities.” The Hearing Officer also upheld the Department’s use of a single factor sales formula.

The Hearing Officer distinguished JC Penney, supra, on the grounds that Penney’s retail stores conducted no activities that assisted the Taxpayer in that case in maintaining its credit card business in Tennessee

The Hearing Officer also concluded that the royalties were subject to the gross receipts tax.


1. Facts. ADP is a New Jersey-based corporation engaged in providing a wide range of information and computing services to private business and government clients. In the 1980's ADP established four wholly owned subsidiaries to manage certain intangible property. One subsidiary, originally capitalized with cash and marketable securities, engaged in the business of lending funds to ADP. Another held the “ADP” trademark, charged a royalty fee to ADP and other subsidiaries for its use, and invested the proceeds. The remaining two subsidiaries were capitalized with marketable securities, which they managed and reinvested. The
subsidiaries had few employees and their officers and directors were largely directors and high-ranking employees of ADP.

2. **State Attack.** In 1992, the Illinois Department of Revenue audited ADP and its subsidiaries for the tax years 1987 through 1989. The DOR determined that the ADP group had understated its Illinois taxes for these years because it had improperly failed to include these subsidiaries or their income in its calculation of Illinois taxable income. Following an administrative decision confirming the resulting assessment, ADP sought administrative in the Circuit Court of Cook County. After the circuit court affirmed the ALJ’s decision, ADP appealed to the Appellate Court.

On appeal, ADP challenged the DOR’s assessment on the grounds that (1) the subsidiaries’ income would not have been nonbusiness income allocable outside Illinois if it had been earned directly by ADP and therefore should not be treated as unitary business income; (2) apportioning the income by means of the ordinary three-factor formula grossly and unfairly distorted ADP’s Illinois taxable income, so that ADP was entitled to discretionar y apportionment; and (3) the subsidiaries were “investment companies” and therefore qualified as “financial organizations” that were properly excluded from ADP’s unitary business group.

3. **Holding.** Addressing ADP’s positions in turn, the Appellate Court first rejected the argument that the subsidiaries’ income was not business income. According to the court, the burden was on ADP to show that the income was not business income, and given the facts, the ALJ and the DOR were correct in determining that the income in question satisfied both the functional and transactional tests. In so holding, the court focused on the fact that, both before and after creation of the subsidiaries in question, ADP regularly invested in marketable securities. However, the question is properly whether that activity was unitary with ADP’s regular business conducted in Illinois. Thus, the court’s analysis was not particularly convincing.

4. **Three Factor Apportionment Not Distortive.** The court next turned to ADP’s argument that using the three-factor formula to apportion the income of the subsidiaries constituted a gross distortion that would justify its use of an alternative apportionment formula. According to the court, even if it were to accept the distortion testimony of ADP’s expert, the income apportioned to Illinois under the regular formula was only 8 percent higher than under the alternative American Home Products formula proposed by ADP, falling short of a situation requiring relief under the Due Process and Commerce clauses of the U.S. Constitution. The court also relied on the administrative law judge’s finding that the income generated by ADP’s subsidiaries was subsequently used by ADP in its business and that ADP engaged in substantial income-producing activities in Illinois. Accordingly, the court concluded that it was fair for the DOR to utilize the three-factor formula to apportion some of that income to Illinois.
5. **Taxpayer Tries to Defend Subs as “Financial Institutions.”** Finally, the court addressed the principal issue of interest to other taxpayers – whether the subsidiaries qualified as “financial organizations” required by Illinois law to be excluded from ADP’s unitary business group. ADP claimed that its subsidiaries qualified under the “investment company” category of financial organization. The DOR claimed that the term “investment company” was limited to companies subject to regulation under the federal Investment Company Act of 1940, a definition that admittedly would not include the subsidiaries in issue. Finding the issue to be a “mixed question of law and fact,” the court held that it must review the DOR’s determination of the subsidiaries’ classification under a clearly “erroneous” standard review that accords substantial weight and deference to the DOR’s interpretation of the Illinois statute.

In the absence of a statutory definition of “investment company,” the court agreed with the parties that the term should be accorded its ordinarily understood meaning. The court examined ADP’s contention that such meaning is found in standard references such as Black’s Law Dictionary, which defines the terms to include “an issuer which...is or holds itself out as being engaged primarily...in the business of investing” apparently without regard to the fact or degree of governmental regulation. On the other hand, pointing to the fact that the above definition appears to be taken from, and actually cites, the federal Investment Company Act, as well as to a second definition of the term as equivalent to a regulated mutual fund, the court also agreed with the DOR that Black’s definition arguably limited the term “investment company” to government-regulated entities.

Acknowledging that reasonable arguments favored both interpretations, the court held: “In the presence of this ambiguity, we defer to the Department’s reading.” In support of its holding, the court found, that under ADP’s broad interpretation of the terms, every company that invested in another company would qualify as an “investment company” and “three-factor apportionment would be an exception rather than the rule,” which “[w]e do not think...would comport with legislative intent.” The court also found the DOR’s narrow definition “more compatible with the spirit behind combined reporting,” because “functionally integrated companies are best combined in one group when feasible.”

It should be noted that the court in ADP failed to address the rationale recently advanced by the circuit court in *Dover Corp. v. Illinois Department of Revenue* (Circuit Court of Cook County, Jan. 14, 2000). In *Dover*, the court ruled that subsidiaries established for the sole purpose of managing a corporate group’s excess capital and intercompany debt obligations qualified as “investment companies,” as well as “private bankers” and “industrial bankers,” all “financial organizations” under Illinois law. In addition to finding that these labels accurately described the subsidiaries’ income – interest, dividends, and capital gains – was exactly the type of income that the “financial organization” formula was specifically designed to apportion. If ADP’s appeal is rejected by the Illinois
Supreme Court – a likely result – Dover’s pro-taxpayer decision will almost certainly be overturned, as that appeal is to the same appellate court that decided ADP.

ADP will petition the Illinois Supreme Court for leave to appeal the Appellate Court’s decision.


1. **Facts.** Parent operating companies transferred tax-free to and licensed back from two Delaware subsidiaries its trademark intellectual property. It claimed over $100M in deductions for royalties to its wholly-owned subsidiaries, each of which was a Delaware intangibles holding company.

2. **State Attack.** The Massachusetts Appellate Tax Board (ATB”) found that transactions consisting of the transfer of certain trademarks and tradenames to the subsidiaries and the subsequent license of those intangibles back to Sherwin-Williams lacked business purpose and economic substance. Accordingly, based on the sham transaction doctrine, the ATB ruled that the adjustments made by the Commissioner were proper. The ATB rejected each of the business purposes asserted by Sherwin-Williams in support of the transactions. In its view, each of the non-tax business purposes alleged by the corporation either could not be achieved, had already been achieved prior to the transactions, or would actually expose the corporation to serious economic risk. Moreover, enhancement of licensing opportunities was not a valid business purpose because the corporation would have no interest in increasing the royalty rates to which it, as a licensee, would have no entitlement.

The transactions lacked economic substance because no risk of loss to the corporation was created by the transfers to its wholly owned subsidiaries and it retained all the benefits and control with respect to the trademarks. Furthermore, no practical economic effect resulted from the transfer and license-back transactions given the possible circular flow of funds among the entities. In addition, the ATB ruled that the deductions were properly disallowed based upon the substance over form doctrine. The ATB concluded that despite the form of the transactions, “[t]he original owner of the Marks was still in exclusive control of them and retained all the benefits from them; nothing of substance changed as a result of the transactions.”

The ATB also found that the payment of royalties by Sherwin-Williams to its wholly-owned subsidiaries was not deductible as an “ordinary and necessary” business expense. To be deductible, the ATB concluded that there must be some valid business purpose justifying the payment of royalties for the use of the intangibles, other than a mere paper agreement between the parent and its subsidiaries. Based on the record, the ATB found that the transfer and licensing transactions between the entities should have been royalty-free. The ATB
determined that it was Sherwin-Williams that maintained the value of the intangibles and that the subsidiaries “had not developed the Marks in any way, or built any goodwill, or created anything of value that could be licensed back to the parent.” The court found that the corporation and the subsidiaries had interlocking directors and officers, the corporation paid the majority of expenses and retained ultimate control of the trademarks, it remained responsible for all advertising and substantially all quality control relative to the trademarks, and the subsidiaries relied on the corporation to solicit third-party license agreements.

Finally, the ATB ruled that the Commissioner had properly exercised his authority to make an arm’s length adjustment under M.G.L. c. 63, §39A. Moreover, the ATB did not find the taxpayer favorable cases cited by Sherwin-Williams, e.g., New York City’s In re Toys “R” Us-NYTEX, Inc. and Maryland’s SYL, Inc., to be persuasive, because the Commissioner did not disregard the subsidiaries as valid corporations and did not attempt to combine all the income of the subsidiaries into the parent.


1. **Facts.** Delaware holding company (Syl, Inc.) formed as subsidiary of Syms to hold trademarks of Syms, nationwide apparel retailer. Syms transferred to Syl and Syl licensed back to Syl marks for net sales royalty of 4%. Syms jumped the gun and deducted some royalties to Syl before its creation and transfer of the marks. Annual royalty also always followed by tax free dividend payment by Syl back to Syms. Over multi-year period Syms paid $10 million in royalties to Syl based on nationwide sales. Syl has only a part-time “shared” employee and “shared” office in Delaware. No third party licensing or contemporaneous 482 study was done.

2. **State Attack.** Mass.Commissioner denied Syms the royalty deduction to Syl on grounds that the deduction was a distortion of Syms’ Mass. income.

3. **Holding.** Following closely, if not precisely, the reasoning it adopted in Sherwin-Williams, the Court held the “canned” business purpose and “pure paper shuffle” of the Syms-Syl relationship did not support the claimed deductions.

III. The Legal Theories – For What It’s Worth

A. Sham/Lack of Economic Substance

B. Section 482 Reallocation/Lack of Arm’s Length Pricing and Terms

C. Distortion of Income

D. Economic Nexus
E. Agency Nexus  
F. Lack of Business Purpose  
G. Anti-PIC Legislation or Regulation (e.g., Connecticut, Ohio)  
H. Step Transaction  

IV. Remedies Used By The Courts  
A. Forced Combination or Consolidation  
B. Disallowance of Outbound Deduction  
C. Separate Filing Based On Finding of Nexus  
D. Factor Manipulation  

V. Critical Factors  
A. Avoid Selecting Poor Candidates Where Preexisting Facts Are Not Good  
   1. Business Purpose and Existing Practices  
B. Implementing Poorly  
   1. After-the-Fact Section 482 Transfer Pricing Studies  
   2. Lack of Substance  
C. Operational Neglect  
   1. Not Paying Interest on Royalty When Due, e.g. Overnite  
D. Assess a Court’s Predisposition in Tax Cases  
   1. Facts, Facts, Facts
VI. "Current Best Practices"

A. Aligning Tax Objectives With Other Business Imperatives

1. Business Purpose is Obvious and Organic
2. Implementation is Easy
3. Operation is Easier

B. Embedded Royalty Structures

1. Using the Natural Protection of P.L. 86-272
2. Typical Contexts
   a. Contract Manufacturing
   b. Customer Relationship Management