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# INTA Emerging Issues Tax Subcommittee
## Report on IP Holding Company Case Law in the United States[1]

### Executive Summary

Establishing a trademark or intellectual property holding company ("IP holding Company") in another state is an increasingly common but oftentimes risky venture. Although IP holding companies can collect substantial licensing royalties and potentially save a business millions of dollars in state taxes, this tax avoidance/tax minimization mechanism has recently been subject to an increasing number of successful legal challenges by various states of the U.S. When the IP holding company is not set up and run properly, it can also backfire even in tax-favorable jurisdictions. In 2001, for example, the New Mexico Court of Appeals ordered Kmart to pay $ 2.7 million in back taxes, interest and penalties to the State of New Mexico based on its establishment of an IP holding company in Michigan.

Section 1 of this paper begins with a discussion of the legal precedents and principles applicable to the taxability of royalties paid to an out-of-state holding company; this is followed by a review of the fundamental Supreme Court cases and other key court decisions addressing jurisdictional principles, including when a state has the general right to tax a business entity located in another state. Section 2 addresses specific cases involving IP holding companies, grouped according to whether the IP Holding Company was considered a legitimate entity and those where it was found to be a sham entity otherwise subject to tax liability. Section 3 mentions other implications for trademark owners arising from these cases (regarding possible trademark validity and jurisdictional and venue issues). The paper concludes by recommending that INTA continue to study the emerging case law in this area and perhaps devote resources to a similar study internationally. Finally, an attached chart lists many of the recent IP holding company cases. The chart contains an illustrative list of various factors particular courts consider in determining whether the holding company was found valid or subject to tax liability.

### Introduction

A state that attempts to tax an entity in another state raises at least the possibility of burdening interstate commerce and running afoul of the Constitution's Commerce Clause. With

[1] This paper does not constitute legal advice and should not be relied upon as such. The factors examined in the case law discussion and accompanying chart are for illustrative purposes only and have not been fully exhausted.

this in mind, businesses have adopted various strategies for shifting their tax burdens in higher-tax states to lower-tax states. One relatively recent strategy involves establishing an IP holding company subsidiary in a lower-tax state. The business transfers ownership of its marks to the IP holding company, which then licenses the marks back to the business in exchange for royalty payments. The payments come from components of the business in higher-tax states, where they are later deducted as a business expense. These payments are taxed to the holding company by the lower-tax state if they are taxed at all. Certain states do not tax royalty income. Many IP holding companies choose to incorporate in Delaware to take advantage of this strategy. Regardless, higher-tax states have attempted to reach into the lower-tax states and tax the holding companies, although with varied success. The outcome often depends on the specific facts in each case and how the holding company has been established and run. Before turning to a discussion of specific IP holding company decisions, this paper first explores in Section 1 several fundamental cases (not necessarily in chronological order) in which taxpayers have challenged the ability of a state to levy taxes generally under the Commerce Clause.

## Section 1 – Background Case Law Affecting IP Holding Companies

### Quill: No Physical Presence, No Substantial Nexus, No Tax Payable

The United States Supreme Court set forth the standards by which one state may tax a business in another state in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), a case cited by almost every subsequent case involving the taxation of an IP holding company. In *Quill*, the Court recognized that although the Commerce Clause expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several States," it says nothing about preventing the states from interfering with interstate commerce. U.S. Const. Art. I, § 8, cl. 3. And yet, such a negative sweep to the Commerce Clause has been recognized judicially since the nineteenth century. *See Gibbons v. Ogden*, 22 U.S. (9 Wheat). 1, 231-232, 239 (1824) (Stone, J., concurring).

*Quill* involved North Dakota's attempt to tax an out-of state mail order company with few contacts with the taxing state. Before *Quill*, the U.S. Supreme Court had established a four-part test to determine whether one state's taxation of a business entity in another state is constitutional under the Commerce Clause. The rule provided: a state tax is not barred by the Commerce Clause if "the tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

The general rule for sales and use taxes states that the "substantial nexus" test is not satisfied if the taxed entity has no physical presence in the taxing state. *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967). None of Quill's employees worked or resided in North Dakota. Quill's ownership of tangible property in North Dakota was either insignificant or nonexistent. Quill solicited business through catalogs and flyers, advertisements in national periodicals, and telephone calls. Its annual national sales exceeded $200 million, of which almost $1 million was made to about 3,000 customers in North Dakota. It delivered all of its merchandise to its North Dakota customers by mail or common carrier from out-of-state locations. The Court determined that Quill lacked the necessary “substantial nexus” with the taxing forum, so North Dakota’s tax was declared unconstitutional. *Quill, supra*.

Scripto: No Physical Presence, Independent Contractors Used, Sufficient Nexus, Tax Payable

In a somewhat different analysis, the U.S. Supreme Court has examined in two cases whether one state may impose a tax on the general business activities of an entity in another state when those business activities had a minimal nexus with the activities taxed by the taxing state. In *Scripto, Inc. v. Carson,* 362 U.S. 207 (1960), the Court considered whether Florida could levy a tax forcing nonresident corporations to collect a tax from consumers on the property they ship for sale in Florida when the nonresident corporations have no presence in Florida other than independent contractors that sell their products. The Court found that Florida could impose a requirement on corporations to collect taxes from consumers for products they sell to those consumers. This was true even where the corporations were not Florida corporations, maintained no office or assets in Florida and employed no Florida residents. In analyzing the legality of the tax, the Court found that there was a constitutionally sufficient nexus (similar to but perhaps a lower threshold than the Supreme Court's "substantial nexus" requirement) between the state of Florida and Scripto. The Florida tax statute did not impose a tax on Scripto itself, but rather on the consumer. Scripto was merely burdened with the duty of collecting that tax, and the state would credit Scripto for its efforts. The Court also determined that the use of independent contractors, some of whom worked for other principals, in lieu of employing a sales force, did not change the constitutional analysis because the company derived the same benefit from the independent contractors that it would from employees and did not change Scripto's effectiveness in securing a substantial flow of goods into Florida. Therefore, Scripto was held liable under the tax collection statute.

Tyler: Independent Contractors, Substantial Nexus, Tax Payable

Likewise, in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987), the Court considered whether a nexus could be established sufficient for taxation based solely on the presence of independent contractors in the taxing state who acted as sales agents for a business in another state. The state of Washington sought to tax petitioner, Tyler Pipe Industries, whose only contact with the taxing state was its independent contractor sales force in Washington. The critical question concerning the substantial nexus required to justify the tax was "whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." Here, the Court found that the sales representatives provided Tyler Pipe with virtually all their information regarding the Washington market, including: (1) product performance; (2) competing products; (3) pricing, (4) market conditions and trends; (5) existing and upcoming construction products; (6) customer financial liability; and (7) other critical information of a local nature concerning [the] market.” The Court therefore concluded that there was no constitutional distinction between employees and independent contractor sales agents. It found that the activities of the independent contractors' on Tyler Pipe's behalf were sufficient to establish a substantial nexus between Tyler Pipe and the state of Washington, This conclusion justified Washington's tax on the out-of-state Tyler Pipe.

Geoffrey: No Physical Presence, Substantial Nexus, Royalty Payments Taxed

Since the Supreme Court's decision in *Quill*, many state courts have adopted the physical presence requirement in a variety of different circumstances, with varying results. In South Carolina, for example, the Court found no physical presence was required to establish a "substantial nexus" to properly tax royalty payments as income to an out-of-state entity. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C.), cert. denied, 510 U.S. 992 (1993). In this controversial and widely publicized case, Toys "R" Us established in Delaware a wholly owned IP holding company, to which it transferred the TOYS R US mark with a license back. Toys R Us paid its holding company 1 percent of sales in South Carolina, and deducted this amount from its South Carolina taxable income. When South Carolina attempted to tax the deducted amount as income to the IP holding company, the IP holding company argued that such a tax was unconstitutional in light of the Commerce Clause. The Delaware holding company had no physical presence in South Carolina, and therefore, such a tax on its income contravened the holdings of *Complete Auto Transit* and *Bellas Hess*. The Court, noting that (as discussed in *Quill*) the physical presence requirement of *Bellas Hess* did not extend from the sales and use tax to other kinds of taxes, held that licensing intangibles and deriving income from their use establishes a substantial nexus with a state. As a result, the income tax was upheld.

J.C. Penny: No Physical Presence, No Substantial Nexus, No Tax Payable

In Tennessee, where the courts have not addressed intellectual property rights per se but have addressed taxation of revenues derived from other intangible services, there appears to be more reluctance to abandon the Supreme Court's physical presence requirement. In *J.C. Penny National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2002) the Tennessee Court of Appeals reversed the imposition of excise and franchise taxes applied to credit card activities of an out-of-state credit card issuer, J.C. Penney National Bank, even though customers received solicitations and used the credit cards within Tennessee. The court determined that the credit cards were "merely representative" of the customers' accounts, but the actual accounts, and revenues derived from those accounts, were located in Delaware, where the issuing bank was domiciled. The Tennessee court also rejected the argument that services being provided in Tennessee by other companies were necessary to the generation of revenues from the state to satisfy the nexus requirements in *Scripto* and *Tyler Pipe, supra*. Further, the credit cards being distributed and used in Tennessee were not branded to identify the affiliation of the issuer with J.C. Penney, nor were they affiliated with a local J.C. Penney store. Therefore, the Tennessee court determined that the mere physical presence of the J.C. Penney stores in Tennessee did not satisfy the broader physical presence requirement established by *Quill*. The court was careful to distinguish the generic Visa and MasterCard credit cards at issue from proprietary J.C. Penney-brand credit cards, which were not at issue in the case.

Kmart: No Physical Presence, Substantial Nexus, Tax Payable

In New Mexico, the court of appeals upheld the imposition of sales tax, use tax and income tax on revenue earned by Kmart Properties, Inc., an IP holding company with only one location, in Michigan, that was a wholly owned subsidiary of Kmart Corporation. See *Kmart*

*Properties, Inc. v. Taxation & Revenue Dept. of New Mexico*, Docket No. 21,140s (N.M. Ct. App. Nov. 27, 2001). Kmart Properties' sole source of revenue derived in New Mexico consisted of royalties from Kmart stores (owned by Kmart Corporation) located within the state, which the tax commissioner contended justified all three types of taxes. Kmart, in setting up an IP holding company, was following advice widely advocated to the corporate community at the time by various accounting firm giants–in this case, PricewaterhouseCoopers LLP (PwC). A PwC consultant testified in this case that he had personally helped set up more than 50 IP holding companies. Kmart was following a plan espoused by the firm that was actually titled "Utilization of an Investment Holding Company to Minimize State and Local Income Taxes."

Keeping this background in mind, the New Mexico Court of Appeals rejected any physical presence requirement for the income tax. With respect to the sales and use taxes, however, the court further evaluated the practice of imposing a physical presence requirement to satisfy the "substantial nexus" prong of the Commerce Clause analysis and determined that "a trademark and its goodwill are inseparable property rights that, as a practical matter, are bound to the business that generates the goodwill." Accordingly, the physical presence of Kmart stores and Kmart products that embodied the goodwill inherent in Kmart Properties' trademarks was sufficient to establish the "functional equivalent" of physical presence of the holding company in New Mexico to justify the sales and use taxes imposed by New Mexico on the Michigan-based holding company. Using creative reasoning, New Mexico followed the trend of other states by attempting to find ways around the physical presence requirement of *Quill*. Interestingly, the court took the concept of "intangible" property and the concept of intangible "goodwill" from trademark law and used them to convert the mere presence of intellectual property into the functional equivalent of a physical presence in the state. Under the New Mexico court's logic, it appears almost any fairly well known trademark could establish tax liability in virtually every state.

America Online: Physical Presence Not Required To Establish Substantial Nexus

Appearing to follow the trend seen in *Geoffrey* and *Kmart*, the Tennessee Court of Appeals again considered taxation on intangible services and this time appeared to be more receptive to imposition of the tax. See *America Online, Inc. v. Johnson*, Case No. M2001-00927-COA-R3-CV, 2002 WL 1751434 (Tenn. Ct. App. July 30, 2002). In this case, AOL's Internet Service Provider services were at issue. Although the court of appeals did not actually uphold the imposition of the tax at issue, it reversed summary judgment against the tax commissioner and remanded the case for further fact-finding. While purporting to follow the same standards in *J.C. Penney, supra*, the appellate court rejected the notion that actual physical presence was always required. It directed the trial court to consider the extent of AOL's relationship with various network service providers and remote staff that were located in Tennessee in order to determine whether those relationships "substantially contribute to the taxpayer's ability to maintain operations within the state" and, therefore, would subject AOL to taxation under long-established precedent. As in the *Kmart* case, the implications of tax liability under the court's analysis are substantial. The Internet, by its very nature, requires routers, servers, transmissions and connections, which pass through every state and country in the world. The Tennessee court's analysis, if followed and expanded upon, could have sweeping implications for businesses engaged in Internet services or e-commerce services.

MCIIT: No Physical Presence, No Nexus, No Tax Payable

In a recently decided case, the Maryland Court of Appeals overturned a determination by the Maryland Comptroller that a subsidiary of MCI Telecommunications Corporation ("MCIIT") was a phantom corporation and not a substantial entity, established to help its parent avoid paying state income taxes. The court demanded that MCIIT pay taxes for business conducted in the state. *MCI International Telecommunications Corp. v. Comptroller of the Treasury*, 1999 WL 322702, 1999 Md. Tax LEXIS 5, (Md. T.C. Apr. 26, 1999), *remanded by* 2004 WL 1646496, 2004 Md. LEXIS 454 (Md. July 26, 2004). MCIIT, a long-distance telecommunications carrier, specialized in overseas communications and linked overseas phone companies with domestic companies to manage international calls. With the assistance of its parent corporation, MCIIT set up arrangements with both international and local carriers to route inbound and outbound international calls. Fees were paid by MCIIT to the domestic carriers and to MCIIT by the international carriers for the calls. Calls were routed through a gateway located outside of Maryland.

The Maryland court found MCIIT to be a substantial economic entity, and not a phantom corporation, with no nexus to the state of Maryland. Despite its close relationship with the parent, MCIIT still engaged in economic activity apart from the parent, maintaining its own property, incurring personnel expenses and earning revenues from non-affiliated entities. Given this and MCIIT's lack of actual contacts with the state of Maryland, the court found no nexus with the state and, therefore, held that MCIIT could not be taxed by the state.

Zebra: Minimal Connection, Tax Payable

In 2003, the Illinois Appellate Court upheld the imposition of tax in *Zebra Technologies Corp. v. Treasurer*, 799 N.E.2d 725 (Ill. App. 3d 2003). In *Zebra*, the petitioner taxpayer, a Delaware corporation headquartered in Illinois, sought to exclude from taxation certain interest income earned by one of its subsidiaries (a Delaware corporation located in Delaware) that was used to purchase another company. The taxpayer contended that none of the income at issue was used for operational purposes and, therefore that the imposition of tax on this income would violate the Commerce Clause. To determine whether there was a minimal connection between the state and the transaction it sought to tax, the court looked to *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), which held that a state may impose tax on the multistate income of a non-domiciliary corporation if there is a minimal connection between the corporation's activities and the taxing state. The court also considered the rational relationship between the income sought to be taxed and the intrastate value of the corporate business. Under the operational function test of *Allied-Signal*, a court may apportion interest income when a capital transaction serves an operational rather than an investment function. In upholding the state's right to tax the petitioner, the court found that the portion of the subsidiary company's interest income that was used for the purchase of a business furthered the taxpayer's business, because it affected the parent company's value, and therefore, that portion was taxable.

Lanco: No Physical Presence, No Substantial Nexus, No Tax Payable

Another relatively recent IP case to consider jurisdictional issues is *Lanco, Inc. v. Director, Division of Taxation***,** 21 N.J. Tax 200 (N.J.T.C. Oct. 23, 2003). This case involved whether New Jersey could subject a foreign IP holding company, Lanco (owner of the LANE BRYANT mark), to the state's corporation business tax when the corporation had no physical presence in the state and derives income only pursuant to licenses through its IP holding company. The New Jersey Tax Court engaged in an extensive review of the prior case law, including *Complete Auto Transit*, *Quill, Bellas Hess, Scripto*, *Geoffrey*, and other decisions. It considered whether the physical presence requirement, enunciated in *Quill*, applied only to the use tax at issue in that case or be expanded as a necessary element to require a substantial nexus for state income or franchise taxes. Based on its extensive review of the case law, the court found that the physical presence of the taxpayer or its employees, agents or tangible property in a jurisdiction is also a necessary element for a finding of a substantial nexus under the Commerce Clause. From a policy perspective, the court found that any business should be free to try to minimize its taxes through legitimate means and held that the "taxing authority is similarly bound where the taxpayer has chosen shrewdly."

A&F Trademark: No Physical Presence, Substantial Nexus, Tax Payable

The North Carolina Court of Appeals, however, chose to disagree with the New Jersey court's analysis in *Lanco*. Furthering the trend of *Geoffrey* and *Kmart*, the North Carolina court in *A&F Trademark Inc. v. Tolson*, No. COA03-1203 (N.C. Ct. App.Dec. 7, 2004) declined to follow any physical presence requirement with respect to the income and franchise taxes imposed on the IP holding company that licensed trademarks to The Limited, Inc. The taxpayers in *A&F Trademark* are IP holding companies that earned, in 1994 alone, more than $301 million in royalties and $122 million in interest for licensing and loan agreements with The Limited retailers. When the state secretary of revenue assessed corporate franchise and income taxes against the taxpayers, the IP holding companies challenged the taxes under both state statutory interpretation and the dormant Commerce Clause. The North Carolina Court of Appeals affirmed the state's right to assess both income taxes and franchise taxes on an IP holding company's licensing of trademarks to retailers within the state.

The court quickly rejected any contention that the IP holding companies were not "doing business" in North Carolina under the relevant statutes authorizing both the income and the franchise taxes, including an amendment titled "An Act to Combat Tax Fraud, Enhance Corporate Compliance with Taxes on Trademark Income, [and] Assure that Franchise Tax Applies Equally to Corporate Assets." According to the court, the very title of that amendment signaled the state's frustration with corporate attempts to avoid tax liability.

Turning to the Commerce Clause analysis, the North Carolina court considered and flatly rejected any application of the physical presence requirement. The court first followed the "tone" of the *Quill* opinion, which was "hardly a sweeping endorsement" of the bright-line physical presence requirement the *Quill* Court preserved from *Bellas Hess*. Second, the court followed *Quill*'s recognition of other decisions that had declined to extend the physical presence test to other types of taxation, thereby giving North Carolina an excuse not to follow *Bellas Hess* at all. Third, the court determined that franchise and income taxes imposed on IP holding companies for licensing and policing trademarks were so different from the sales and use taxes that the rationale behind the physical presence requirement simply did not apply. The North Carolina court, therefore, purported to follow *Geoffrey* and *Kmart* by singling out IP holding companies, and held: "where a wholly-owned subsidiary licenses trademarks to a retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause." Thus, North Carolina obliterated any physical presence requirement, or other Commerce Clause obstacle, as applied to IP holding companies.

**Summary/Conclusion – Section 1**

A state thus can tax an entity in another state only if it can show that the entity has a substantial nexus with the taxing state. As noted above, in 1992, the U.S. Supreme Court held in *Quill* and *Bellas Hess* that a taxed entity must have a physical presence in the taxing state to satisfy the substantial nexus requirement. Since then, the U.S. economy has transformed itself from a manufacturing economy based primarily on the creation and sale of tangible articles to a service economy in which intangible property is often the subject of commercial transactions. This evolution has diluted the relevance of physical presence as a meaningful way to determine whether an entity has a "substantial nexus" with a given forum. As discussed above, state courts often have found ways to meet the substantial nexus requirement for out-of-state holding companies whose only footprint in the taxing state is their licensed trademark rights. Thus, the physical removal of the holding company from the taxing state alone may no longer be a reliable way of shifting at least some of a business's tax burden from a higher-tax state to a lower-tax state. State taxing authorities, aided by their state's courts, have grown increasingly intolerant of companies' attempts to avoid taxation on intangible services. Extending that trend to IP holding Companies, the *Geoffrey*, *Kmart*, and *MCI* cases demonstrate that states have broadened their interpretation of the Commerce Clause "substantial nexus" requirement to prevent larger companies from reducing their tax burdens in the particular state (and many other states) by setting up isolated IP holding companies elsewhere. Recognizing the growing importance of intellectual property to corporations' assets and revenues, states have now taken yet another approach to impose taxes on IP holding companies even where the royalties and other revenues might not otherwise be taxable–characterizing the IP holding company as a sham.

In Section 2, we look at cases where the courts have protected the IP holding company from state tax liability and other cases where courts have found particular IP holding companies liable for state taxes. Section 3 lists various factors that may have resulted in the finding of liability or no liability. The factors may be used to draw tentative conclusions as to which measures reduce or increase the vulnerability of IP holding company royalties to out-of-state taxation.

**Section 2 – Cases Involving IP Holding Companies**

Introduction

The cases discussed in Section 1 are heavily relied upon in specific cases involving IP holding companies. Each of the cases below considered the applicable state's disallowance of deductions a company had taken for royalty payments made to its wholly owned IP holding company. There are a few states, notably Delaware and Michigan, which do not tax royalty income. As a result, many companies take advantage of the law by setting up an IP holding company in those states and transferring their trademark portfolio to the holding company in return for all of the holding company's stock. Once the IP holding company is established, it then charges the parent a royalty to license the use of the applicable trademarks. This license fee can greatly reduce the parent's yearly income and, thus, its tax burden.

In the first group of cases reviewed below, the IP holding company was considered a legitimate legal entity and the deduction was allowed. In the second group of cases, the court held the IP holding company to be a sham and nothing more than a tax avoidance scheme, therefore disallowing the deductions the parent had taken.

Cases in Which Courts Allowed IP Holding Companies

In cases where the use of IP holding companies have been upheld, courts have considered a number of factors, including whether the holding company serves a valid business purpose; whether it is actively involved in the registration, protection and enforcement of the trademarks, and whether transactions between the holding company and the parent, including the trademark license agreements and royalty rates, are to be considered at arm's length. Courts often look to expert testimony on these issues.

*In re Express, Inc.*, DTA Nos. 812330-812332, 812334, 1995 N.Y. Tax LEXIS 493 (N.Y. Div. Tax App. Sept. 14, 1995)

In 1995, the New York State Division of Tax Appeals looked at the respective trademark protection companies of the retailers Express, Inc., Limited Stores, Inc., Lane Bryant, Inc. and Victoria Secret, Inc. Finding that each of the trademark protection companies was a viable corporation, engaged in the registration, protection and enforcement of the respective marks, the Division concluded that the petitioners-retailers were able to rebut the presumption of income distortion by establishing that the licensing arrangements were arm's-length transactions. The existence of actual income distortion in connection with the royalty rates and interest rates on inter-company loans had not been established. Therefore, the petitioners-retailers were not required to file combined tax reports.

In *Express*, the Division found the following factors to be probative: (1) the trademark protection companies had directors who were not previously affiliated with the associated retail companies; (2) the trademark protection companies hired an independent valuation firm to determine appropriate royalty rates for the trademark licenses; (3) the trademark protection companies had very proactive, engaged trademark counsel who maintained the trademark portfolios (consisting of hundreds of registrations around the world) and implemented a quality control plan for each of the retail stores around the world (including regular store inspections and checklists completed by store managers and sent to trademark counsel and the trademark protection companies); and (4) an analysis provided by Coopers & Lybrand showed that royalties (and interest rates on intercompany loans) were arm's-length transactions.

*In re Toys "R" Us-NYTEX, Inc.,* TAT (H) 93-1039(GC) (NYC Tax App. Trib. ALJ Div. Aug 4, 1999)

Toys "R" Us-NYTEX, Inc. is a New York State corporation and wholly owned subsidiary of Toys "R" Us, Inc. (Toys, Inc.). In 1984, Toys, Inc., a Delaware corporation, was restructured, and several new corporations were formed (including Geoffrey; ABG, Inc.; and Toys "R" Us-UK, Inc.), to protect from hostile takeovers as well as for tax planning purposes. In particular, Geoffrey was formed to hold, protect, and create trademarks and trade names. In turn, Geoffrey would charge the other operating companies of Toys, Inc. a royalty (1%) for nonexclusive use of the trademarks and trade names. Geoffrey maintained an office in Delaware with one part-time employee to keep books.

Toys "R" Us-NYTEX, Inc. filed a petition with the Commissioner of the New York City Department of Finance to request redetermination of a deficiency of general corporation tax (GCT) for the years ending February 2, 1986, February 1, 1987, and January 31, 1988. While the statutory preference for corporations doing business in New York City is to file GCT reports on an individual basis, the City argued that Toys "R" Us-NYTEX, Inc.'s income and general corporate tax liability would not be properly reflected unless the related corporations were required to be included in a combined report with Toys "R" Us-NYTEX, Inc. and other Toys "R" Us affiliates. The City claimed that the 1984 initial capital contributions made by Toys, Inc. to the related corporations in return for 100 percent of the stock of each related corporation and the subsequent transactions between the related corporations and Toys, Inc., should be considered as integrated transfers–license-backs and not as separate transactions.

The GCT regulations establish a presumption of distortion where there are substantial intercorporate transactions between members of a related group. There were substantial intercorporate transactions between the related corporations as Geoffrey's income was primarily from royalties it received from licensing intangibles to affiliates. Accordingly, the City believed it was entitled to a regulatory presumption that Toys "R" Us-NYTEX, Inc.'s income was distorted when GCT reports excluding the related corporations were filed. To overcome this presumption, Toys "R" Us-NYTEX, Inc. brought in two expert witnesses who submitted detailed reports to contradict the City's finding and support the transactions as being at arm's length. The City did not offer any expert testimony to rebut or even challenge these conclusions. Ultimately, the transactions between the parent and the operating companies were considered as being at arm's length and combined reporting was not required.

*In re Sherwin-Williams Co., DTA No. 816712 (NYS Div. Tax App. June 7, 2001)*

In *Sherwin-Williams*, the court dealt with the issue of whether Sherwin-Williams should be required to file its franchise tax report in combination with its subsidiaries SWIMC, Inc. and DIMC, Inc.

The New York State Division of Taxation issued a Notice of Deficiency on January 13, 1997, claiming Sherwin-Williams owed additional corporation franchise tax, plus interest, for the years 1987and 1989 through 1991. Sherwin-Williams filed a petition challenging the assertion of additional corporation franchise tax. This was based on its opinion that the Division of Taxation erred in requiring Sherwin-Williams to file a combined corporation franchise tax report with two of its subsidiaries–SWIMC, Inc. and DIMC, Inc. (Sherwin-Williams filed a federal consolidated income tax return for 1991 that included SWIMC, Inc. and DIMC, Inc. The company filed its New York corporation franchise tax report on a separate basis.)

Sherwin-Williams set up SWIMC, Inc. and DIMC, Inc. to manage the Sherwin-Williams trademarks. The companies incorporated in Delaware, were to be afforded additional benefits, such as protection of marks in the event of a hostile takeover, serving as finance and investment vehicles, tax considerations, licensing benefits, etc. A small office, housing both companies, was set up in Delaware. The Sherwin-Williams marks, trade names and service marks, and all goodwill associated with them, would be assigned to the subsidiaries and be nonexclusively licensed back in return for payment of royalties.

The New York Tax Law provides that Division of Taxation may require foreign corporations, subject to New York State tax, to file combined reports with certain other corporations under specific conditions (stock ownership, unitary business test, distortion-of-income test). The stock ownership and unitary business requirements were met in this case. However, Sherwin-Williams contended that the presumption of distortion requirement had not been met, and therefore that a combined report was not required. On the contrary, SWIMC, Inc. and DIMC, Inc. derived most of its royalty income from Sherwin-Williams; hence, there were substantial intercorporate transactions between Sherwin-Williams and the subsidiaries.

Sherwin-Williams presented testimony of various witnesses to illustrate that Sherwin-Williams, SWIMC, Inc., and DIMC, Inc. should be regarded as separate entities and that various transactions between the companies were made at arm's length. The testimony given supported the decision not to file the franchise reports on a combined basis. The Division of Taxation submitted expert testimony of its own to disclaim the above reports. One witness claimed there was no economic substance resulting from the formation of SWIMC, Inc. and DIMC, Inc., because there was no value added to the trademarks by the formation of these subsidiaries.

The Division of Taxation's primary argument was that Sherwin-Williams's trademark assignment and license-back transactions with SWIMC, Inc. and DIMC, Inc. were distortive by their very nature and, therefore, that it was unnecessary to look to the presumption of distortion created by the substantial intercompany transactions. The Division of Taxation also contended that the record showed tax minimization as Sherwin-Williams' motive for setting up the subsidiaries. Upon a review of articles submitted by the Division of Taxation in support of this view, the administrative law judge advised that the articles were not persuasive and stated that taxpayers are free to structure their business affairs as they choose, including the use of any legal corporate structure to minimize state taxes.

The record established that SWIMC, Inc. and DIMC, Inc. were formed for valid business purposes and carried out substantial business in their own names. The assignment of the trademarks by Sherwin-Williams to SWIMC, Inc. and DIMC, Inc. and the license-back of those trademarks exemplified a valid business purpose, characterized by economic substance and not solely motivated by tax avoidance.

The administrative law judge also concluded that the royalty rates paid by Sherwin-Williams to SWIMC, Inc. and DIMC, Inc. fell within an arm's-length range; the interest rate charged by SWIMC, Inc. on its loan to Sherwin-Williams was arm's-length; the rates charged by Sherwin-Williams for the trademark services performed for SWIMC, Inc. and DIMC, Inc. were at arm's length. Since these transactions were at arm's length, the Division of Tax Appeals held that Sherwin-Williams had rebutted the presumption of distortion arising from the existence of a unitary business and substantial intercorporate transactions. The Division of Taxation had not established the existence of distortion, and it could not require Sherwin-Williams to file a combined corporation franchise tax report with SWIMC, Inc. and DIMC, Inc.

*Sherwin-Williams Company v. Commissioner of Revenue*, 438 Mass 71 (2002)

Under identical facts, the Supreme Judicial Court of Massachusetts considered Sherwin-Williams's appeal from the Appellate Tax Board's disallowance of deductions Sherwin-Williams had taken for royalty payments made to its wholly owned Delaware subsidiaries. The court held that the deduction was acceptable and not a sham transaction. It found probative the following facts: (1) there was a historical trail showing the reason for setting up the subsidiary was not only tax avoidance but also a business need to consolidate the company's trademark portfolio; (2) the trademark license between Sherwin-Williams and the subsidiary was nonexclusive and for a limited term and the subsidiary had the ability to license the marks to third parties; (3) Sherwin-Williams did not license back all of the marks it transferred; (4) an independent appraisal company established the royalty rate the subsidiary charged Sherwin-Williams; (5) the subsidiary retained its own law firm and paid its own legal fees and investment consultant in order to maximize its independence and income; and (6) the subsidiary did not return its income to the parent at the end of the year. All these factors combined persuaded the court that the subsidiary was a viable Delaware business and that therefore, the motivation behind establishing the subsidiary was not merely tax avoidance.

*Acme Royalty Co. v. Director of Revenue, 96 S.W.3d 72 (Mo. 2002)*

Acme Brick (Brick) conducts business in Missouri. Brick established a Delaware IP holding company. Missouri revenue officials claimed that the income received from the royalties paid by Brick to its IP holding company was subject to Missouri taxation. In a 4 to 3 decision, the Missouri Supreme Court disagreed holding that "to qualify as having Missouri source income, the taxpayer must have some activity in Missouri that justifies imposing the tax. Although Acme, Brick, and another entity, Gore, were related to companies that do some business in Missouri, they were each separate legal entities that must themselves have property, payroll or sales in Missouri to be taxed in Missouri. None of these corporations, in fact, had any contact or sales in Missouri; therefore, the income the director attempts to reach is outside the scope of Missouri taxation."

<u>Cases Disallowing the Deduction</u>

In contrast to the cases above, an increasing number of courts have held royalty revenue to be taxable, including when the IP holding company appears to be little more than a vehicle to avoid taxes. A mail drop does not a holding company make. Several of these cases are discussed below.

*In re Burnham Corp.*, DTA No. 814531, 1997 N.Y. Tax LEXIS 304 (N.Y. Div. Tax App. July 10, 1997)

In 1997, the New York State Division of Tax Appeals addressed the question of whether Burnham Corporation, a manufacturer of heating and cooling equipment, and its holding company were required to file combined state tax returns. It found that the Division of Taxation had established that the licensing agreements and royalty payments between the two companies resulted in distortion of New York tax liability, "primarily by separating the intangibles from the expenses associated with creating and maintaining the value of those assets." The Division of Tax Appeals also found that substantial intercorporate transactions created a presumption of distortion, which Burnham was unable to rebut. In contrast to the careful structuring and substantial activities by the trademark protection companies in the *Express* case, discussed above, the Burnham IP holding company had minimal day-to-day operations, exercised little, if any, quality control over the use of the mark and had actually allowed the U.S. trademark registration to lapse. The Division further noted that Burnham had owned the trademark for more than 100 years and over that time had incurred all expenses relating to the trademark and development of its value. After the assignment to the holding company, however, Burnham was still responsible for nearly all of the same expenses (*e.g.* marketing, advertising), and yet now it also had to pay royalties to the holding company. All of these factors combined led the Division of Tax Appeals to conclude that combined tax reporting was required.

*Syms Corp. v. Commissioner of Revenue, 436 Mass 505, 765 N.E.2d 758 (2002)*

In 2002, the Massachusetts Supreme Judicial Court considered an appeal from the Appellate Tax Board's disallowance of deductions Syms Corporation had taken for royalty payments made to its wholly owned Delaware subsidiary. The court reviewed the facts in light of the sham transaction doctrine. This doctrine, based on a review of the facts, holds that if the only purpose of a business-planning model is to avoid taxation, the deduction must be disallowed. Syms contended that the doctrine should not apply, because it had a legitimate business purpose other than tax avoidance.

In reviewing the facts, the court concluded that this was a sham transaction and disallowed the deduction. The court found probative that (1) the subsidiary's board was composed of the CEO and majority shareholder of the parent company, negating any argument about independence and autonomy; (2) the trademark attorney for the parent was also the trademark attorney for the subsidiary; (3) the parent paid all associated legal fees incurred by the subsidiary; (4) the parent oversaw quality control; and (5) even though a 4 percent royalty may have been reasonable in a true arm's-length transaction, nothing of the sort existed here. The Court disallowed the deduction.

*Comptroller of the Treasury v. SYL, Inc. & Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware) Inc.*, 375 Md. 78, 825 A.2d 399, *cert. denied*, 124 S. Ct. 478 (2003)

In 2003, the Maryland Court of Appeals consolidated its ruling in the above cases and overturned the lower court by finding that the subsidiaries in question had no economic substance as separate entities and subjected a portion of their earnings to state income tax owed by the parent corporation. The Court came to this determination by noting that neither the SYL nor the Crown subsidiary had any real economic substance as a separate entity, because neither one could demonstrate evidence of valid business activities. The lack of true full-time employees, the minimal wages paid to part-time employees, offices that served as nothing more than mail drops and the lack of independent business operations, all pointed to the subsidiary corporations' being formed predominantly for the purpose of sheltering income from state taxation. As such, the parent corporations were still liable for state income tax in proportion to the business done in the state by each corporation.

*Zebra Technologies Corp. v. Treasurer,* 799 N.E.2d 725 (Ill. App. 3d 2003)

Also in 2003 (as discussed in Section 1), in connection with a tax issue for a different subsidiary, the Illinois Appellate Court considered in *Zebra Technologies,* whether a parent could exclude certain income from two subsidiaries set up as IP holding companies. Illinois tax law permitted the exclusion from taxation income derived from certain entities in a unitary business relationship with the taxpayer when 80 percent or more of such entities' activities occur outside the taxing state. Zebra formed two IP holding companies and transferred all intellectual property assets to them in return for a 9.5 percent royalty. Zebra moved these companies to Bermuda, where it employed one individual for both companies on a part-time basis to calculate and make royalty payments and engage in other ministerial activities, which included review of quality control reports prepared by the parent's quality control committee. The employee had no previous experience with the management of intellectual property; he performed no quality control or other maintenance activities; and the parent and its employees performed and paid for the function of identifying and protecting intellectual property. The court determined that, although the holding companies were resident in Bermuda and their sole employee resided and worked in Bermuda, a considerable amount of business activity related to the holding companies was performed in the United States, and therefore, the exclusionary rule was not met.

**Summary/Conclusion – Section 2.**

Because there is such disagreement among the various state courts, this issue may ultimately best be resolved by the Supreme Court or by federal legislation that would harmonize and preempt conflicting state court decisions. In order better to draw conclusions from the divergent case law, the report features the attached chart. The chart provides a list of factors that courts have appeared to consider when evaluating whether the IP holding company was a self-sustaining entity. The factors show whether the IP holding company was able to overcome state challenges based on economic substance, business purpose or sham corporation arguments. A review of how the various cases met or failed to meet the factors listed in the chart can be used to draw tentative conclusions as to why certain IP holding companies have succeeded or failed in a very turbulent legal landscape.

In spite of the disagreement among State courts, the effect of these controversies on trademark licensing law has been to more clearly establish that the licensed entity must be more substantial than a shell corporation designed solely or primarily to avoid taxes. Holding companies that have withstood the scrutiny of taxing authorities have had some measure of independence from the parent, have had corporate structures that support such independence and have conducted business activities in their own interests.

Further, the practice of establishing trademark holding companies has inspired several States to adopt legislation specifically disallowing certain trademark royalty payment deductions to holding companies.[2] Each such law differently affects the deductibility of such royalty payments in the State in which it has been passed.

**Section 3 - Other Possible Implications for Trademark Owners**

In addition to the trademark licensing issues discussed above, the cases themselves, while not discussing any substantive aspect of trademark law, raise important questions affecting fundamental issues for trademark owners. For example, a negative ruling in a case involving an IP holding company may have implications in future trademark case law and litigation. For example, if an IP holding company was found to have no legitimate business purpose other than tax avoidance, a defendant in a trademark licensing dispute might raise a defense that the trademark rights are invalid. The defendant would point out that a tax court found the IP holding company to be a sham. Therefore, any license between the operating company and the holding company is a naked license, and likewise, any license from the holding company to the defendant is similarly invalid, resulting in the abandonment of the trademark. Using factors considered by the tax court in rejecting an IP holding company, a defendant could point to factors (such as those outlined in the attached chart), including the absence of proper quality control provisions. A defendant could also raise issues regarding the absence of actual goodwill. A defendant might claim that an IP holding company charged the same royalties regardless of whether or not a mark was even being used or charged royalty rates that were wildly improper and not supported by independent evaluation. Similarly, a defendant might even assert that the IP holding company or the operating company is not the proper party to file the trademark suit.

The tax cases also flag potential jurisdictional and venue issues in future trademark cases. Do these cases mean that an IP holding company can now be subject to jurisdiction and venue in states where it has no physical presence merely because a trademark can be found it that state? As discussed above, in the *Kmart* case, the court of appeals in New Mexico imposed tax on the revenues earned by Kmart Properties, an IP holding company, even though the company had no physical presence in New Mexico. The court found a "substantial nexus," holding that the mere fact that Kmart had stores in New Mexico meant that the "trademark and its goodwill are inseparable property rights, that as a practical matter are bound to the business that generates the goodwill." This case departs widely from prior law, including Supreme Court cases requiring

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[2] Ohio Rev. Code section 5733.042, Conn. Gen. Stat. section 12-218c, Ala. Rev. Stat. section 40-18-35), Miss. Code Ann. section 27-7-17(2)], N.C. Gen. Stat. section 105-130.7A, N.J. Rev. Stat. section 54:10A-4.4, Mass. Gen. Law, Ch. 63, section 31I, N.Y. Tax Law section 208, and Ark. Code section 26-51-423.

that the company being sued have a physical presence in the state.  Using this reasoning, there is a concern that any IP holding company could be subject to jurisdiction and venue in any state in the country (or perhaps the world) because a product, service or facility bearing the trademark happened to be available for sale in that venue.

**Recommendation**

In light of the existing divergent case law and the apparent growing interest by courts to find reasons to tax IP holding companies, the Emerging Issues Tax Subcommittee recommends that INTA continue to monitor the developing case law closely.  We believe it would be fruitful to conduct a similar investigation into international cases addressing IP holding companies. INTA leadership may also decide that INTA should take a more active role on IP tax issues in the future, including filing amicus briefs where appropriate or participating in future state and federal legislative activity affecting IP holding companies and trademark law.