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The Implications of Recent New York Transfer Pricing Decisions for IP Lawyers

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I. Introduction

Eye-catching headlines in the Wall Street Journal seem to crop up with increasing regularity. In September 2006, GlaxoSmithKline agreed to pay $3.4 billion to the IRS to settle a dispute over the transfer prices paid by the United States to the United Kingdom.[1] In November 2006, Merck disclosed that the Canada Revenue Agency had issued the company a notice for $1.8 billion in back taxes and interest related to intercompany pricing matters.[2] Those who do not deal directly with international tax planning may read these articles with a touch of schadenfreude, relieved that the intricacies of transfer pricing are not their worry. But while transfer pricing generally is thought of in the context of international tax, intercompany transactions can result in significant state controversies as well. Moreover, the intercompany licensing of intellectual property, particularly legally protected assets such as patents and trademarks, seems to attract a higher degree of scrutiny from state tax authorities and federal tax authorities than other intercompany pricing arrangements.

This article reviews the New York State Division of Tax Appeals January 2006 decision for Hallmark Marketing Corporation, along with past state decisions involving Lowe's Home Centers, Inc. and The Sherwin-Williams Company. In each case, economic analyses demonstrating compliance with an arm's-length standard were deciding factors in disputes concerning the taxation of profits generated by intellectual property and other intangible assets. Thus, an intercompany license of intellectual property should be structured in conjunction with such an analysis in order to properly assess the risk of future controversy. Related-party transactions, even at the state level, are governed by the federal transfer-pricing regulations.[3] These regulations are continually evolving with significant changes on deck for intercompany transactions involving intangible assets. Several key changes to the regulations concerning intellectual property and services are briefly summarized in this article.

II. Recent Case Law

The State of New York has been at the forefront of the state disputes and initiated the challenge in all three of the cases discussed in this article. In each of these cases, the New York State Department of Taxation argued for "forced combination." That is, a corporation paying New York tax may be required to file a combined report with other corporations that the taxpayer controls if the following three conditions are met:

1. the taxpayer owns or controls substantially all of the stock of another corporation;
2. the group of corporations is engaged in a unitary business; and
3. a distortion of income would result if the corporations reported separately.[4]

In each of these cases, the dispute focused primarily on the third condition: whether a company filing a corporate tax return in New York reported income that was distorted by invalid, or non-arm's-length, intercompany

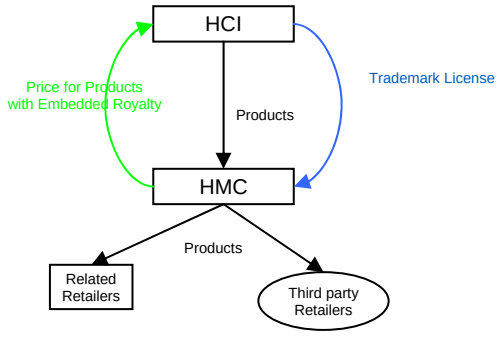
pricing. In each case, the economic analysis conducted to demonstrate compliance with arm's-length behavior was the key determinant.

A. The Hallmark Case[5]

The Hallmark case centered on the Division of Taxation's requirement that Hallmark Marketing Corporation (HMC), a Delaware corporation, file on a combined basis with its parent, Hallmark Cards Inc. (HCI).[6] At the heart of the dispute was whether the profit of HMC was distorted by substantial intercompany transactions.[7] If the Division of Taxation could prove that HMC artificially understated its profit, then it would be able to force the combination of HMC's profit with HCI's profit. Thus, there was an assumption that the transfer prices paid by HMC to HCI for the bundled tangible and intangible property were too high.

HCI was engaged in the design, manufacture, and sale of greeting cards and other social expression products.[8] HMC, acting as the exclusive U.S. distributor, purchased these products from HCI and sold them to third-party retailers.[9] HCI granted HMC a non-exclusive royalty-free license to use various Hallmark-related trademarks within the United States.[10] Figure 1 below depicts the relationship between the affiliates and third parties.

Figure 1: Hallmark Intercompany Transaction Flow Chart



The company structured the intercompany license such that HMC performed routine functions and earned a routine return while HCI was responsible for manufacturing the tangible property sold to HMC and retained all responsibility for developing and defending the intangible property. Therefore, the company argued that HCI should retain any above-normal, or "residual," profit.[11]

The company documented this policy and the results of this policy using the Comparable Profits Method (CPM) as codified in 26 C.F.R. § 1.482.[12] The CPM method compares the operating profits earned by one of the parties to the transaction (the "tested party," in this case HMC), to the operating profits earned by independent companies undertaking similar functions and risks. This benchmark provides a range of routine returns associated with the routine function. This method is thought to produce reliable results when significant economic intangibles are not held by the tested party. The state contended that HMC possessed valuable economic intangibles primarily derived from the presence of Hallmark retail stores that enhanced Hallmark's brand equity and therefore could not be reliably analyzed under the CPM.[13] That is, the operating profits of the selected comparable distribution companies were an inappropriate benchmark by which to measure the adequacy of HMC's profits.[14]
Hallmark prevailed in demonstrating that its intercompany pricing with HCI was consistent with the arm's-length standard.[15] The court agreed that naming HMC as a licensee in an intercompany license agreement did not result in the transfer of any intangibles and that no significant investments of risk were made by HMC.[16] Judge Pinto, in finding in favor of Hallmark, emphasized the taxpayers, "reasonable and flexible approach" and recognized the difficulty taxpayers face when trying to meet the arm's-length standard.[17] His conclusion highlighted that "the goal is not find a perfect or identical comparable, but one which is sufficiently similar."[18] The Division of Taxation is currently appealing the decision.

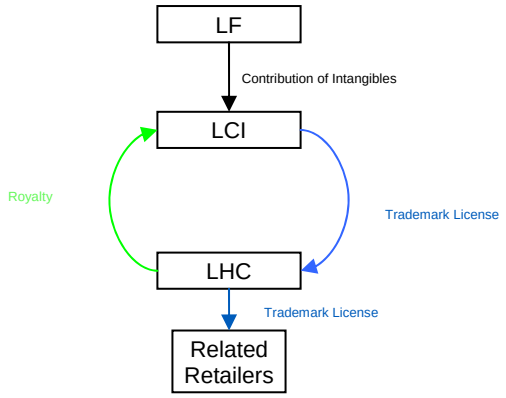
B. The Lowe's Case[19]

Lowe's Home Centers, Inc. (LHC), a subsidiary of Lowe's Companies, Inc. (LCI), is an operator of home improvement centers throughout the United States and serves as the centralized corporate management arm of the Lowe's group.[20] Both LHC and LCI are based in North Carolina.[21] LF Corporation (LF), a Delaware subsidiary of LCI, was created for purposes that included the ownership of trade names and trademarks previously owned by LCI.[22] Prior to this transfer, LCI had permitted the use of its trademarks by various subsidiaries.[23] There were no written licensing agreements and no provisions for royalties.[24] With the new

structure, LFC granted to LCI and LHC as licensees a nonexclusive, nontransferable personal right and license to the use of the trade name and trademarks.[25] A "reasonable and fair" royalty was determined to be 3.4 percent of gross sales.[26] This rate was subsequently reduced to 2.5 percent.[27] Later, it was amended such that LCI's license was non-royalty bearing.[28]

Prior to the formation of LF, LCI owned all trademarks and trade names.[29] Prior to the formation of LHC in 1989, there were no written licensing agreements, no provision for the payment of royalties, and no formal monitoring of the marks.[30] While agreements were put in place upon formation, and royalties were paid, it was not until 1997 that Lowe's used section 1.482 methods to support the intercompany pricing.[31] The various studies that were performed by independent firms between 1997 and 2002 supported the royalty payment using the Comparable Uncontrolled Transaction (CUT) method as well as the CPM.[32] Figure 2 below depicts the affiliates and the transaction flows at issue.

Figure 2: Lowe's Intercompany Transaction Flow Chart



The state argued that LF lacked economic substance and business purpose and that the royalty rates paid to LF were not consistent with the arm's-length standard.[33] In September 2004, after considering the testimony of a number of economists, the court found that the company had not overcome the presumption of distortion of income, *i.e.*, the royalties were not arm's-length, and that the license had no business purpose.[34] In addition, LHC's relationship to related retail operations gave rise to the argument that such retail operations increased the value of the Lowe's marketing intangibles.[35] The court concluded that under the Residual Profit Split Method (RPSM) LF should have been compensating LHC for services that enhanced the value of the trade names and trademarks.[36] The RPSM is applied in cases where both parties are contributing to the development and sustaining activities related to the intellectual property at hand.

C. The Sherwin-Williams Case[37]

The Sherwin-Williams Company is an Ohio-based company engaged in the production and sale of trademarked paints and other surface coatings.[38] Sherwin-Williams Company does business in the State of New York and files a corporate franchise tax return in New York. The trademarks of the company were held and managed by two related Delaware corporations and licensed back to the company in exchange for a royalty based on a percentage of net trade sales.[39] The company deducted these royalty payments, thus reducing its taxable income. The Division of Taxation asserted that the company should file on a combined basis with the Delaware corporations, effectively disallowing the royalty deductions.[40]

An Administrative Law Judge (ALJ) found in favor of the company in June 2001.[41] Two years later, the Tax Appeals Tribunal reversed the ALJ's determination on the ground that the assignment and license-back transactions lacked economic substance and had no business purpose other than tax avoidance.[42] Further, the Tax Appeals Tribunal found that the royalty payments to the Delaware corporations were not arm's length.[43] The company initiated a CPLR article 78 proceeding.

In its October 28, 2004 opinion (corrected February 2, 2005), the New York Court of Appeals upheld the determination of the Tax Appeals Tribunal.[44] The opinion did not address the underlying issues of whether the Delaware companies lacked economic substance apart from tax avoidance or whether the royalty rates were arm's length. Instead, it looked at whether the Tax Appeals Tribunal had substantial evidence on these points in reaching its determination.[45] The Court found that the evidence, which included testimony by the economist who prepared the economic analysis of the royalty rates used by the company and testimony by a professor of economics on behalf of the Division that the royalty rates were not

arm's length, was substantial.[46] Thus, the Court found it had no grounds to overturn the decision.[47]

While structures with Delaware holding companies have become less common with the passage of anti-Passive Investment Company legislation, this case illustrates the centrality of the economic analysis, which followed the federal transfer-pricing regulations.

III. Changes in Federal Transfer Pricing Regulations

It is clear from these decisions that interstate intercompany agreements, particularly those concerning intellectual property, must conform to the federal transfer pricing regulations and that the strength of the documentation demonstrating compliance with these regulations is a factor upon challenge, even by state tax authorities. The federal transfer-pricing regulations are constantly evolving, and, perhaps not surprisingly, the sections on intercompany transactions involving intellectual property have seen the most change in recent years.

A. Cost-Sharing Agreements

While the bulk of the federal transfer-pricing regulations were finalized in 1996, the Treasury and the Internal Revenue Service (IRS) issued proposed regulations to amend IRC §1.482-7, which governs cost-sharing arrangements among related parties, in August 2005. Cost sharing, in the context of transfer pricing, refers to the joint funding of expenditures, such as research and development, for the purpose of achieving joint economic ownership of the resulting intellectual property. The parties to a cost-sharing arrangement agree to share development costs that may result in intellectual property, such as patents, in exchange for a proportional share of the profits from the future use of this property.

Often one of the parties to the cost-sharing arrangement contributes pre-existing intangible assets to the arrangement. The other party (or parties) must compensate the contributing party with an arm's-length payment for the use of the asset. This intercompany payment is known as the "buy-in payment." Valuing the contributed intangibles has been the subject of significant controversy. The proposed cost-sharing regulations introduce the concept of the investor model as the fundamental principle for determining the buy-in payment. Stated simply, the investor model looks to the realistically available alternatives for the contributed intangible to determine value from the perspective of the contributing party. If, for example, the buy-in payment is lower than what the contributing party would earn if it developed and exploited the property on its own, the investor model questions whether, at arm's length, this party would enter into the deal. Taxpayers are not currently bound by these proposed regulations, but they are indicative of the position the IRS, and possibly state tax authorities, are likely to take in these matters.

B. Intercompany Services

More recently, in August 2006, the U.S. Treasury and the Internal Revenue Service tendered temporary regulations on the pricing of controlled service transactions and intangible property ownership. The temporary regulations follow a set of proposed regulations issued in 2003, the first major overhaul of intercompany service regulations since 1968. Importantly, the 2006 temporary regulations follow the approach of IRC §1.482-4 in that for legally protected intangible property, the legal owner is treated as the owner. If the legal owner licenses the rights to another party, the licensee is considered the owner of the licensed rights, and the licensor is the owner of the retained rights. For intellectual property that is not legally protected, ownership is determined by the facts and circumstances regarding the development of the intellectual property.

The implications of the temporary intercompany service regulations for ownership of intangibles are a major focus of these regulations. The primacy of the issue is such that it is addressed in the preamble. The preamble underscores the need for taxpayers to carefully set forth the functions and risks of the related parties in intercompany agreements. The economic substance of the transaction must conform to the legal document, however, if the transaction is to be respected. Changes in the intercompany services regulations are intended to "mitigate the extent to which the form or characterization of a transfer of intangibles as the rending of services can lead to inappropriate results." Taxpayers may elect to use the temporary regulations for tax year 2006. The new services regulations will go into effect for tax years beginning after

December 31, 2007, with some limited exceptions.

IV. Conclusion

Particular care is needed in structuring intercompany transactions involving intellectual property, even when the related parties are both U.S. legal entities. The transaction must be consistent with the arm's-length principle and, as the state tax cases discussed herein demonstrate, documentation of a rigorous economic analysis to this effect is central to the success of sustaining the structure upon challenge.

In each case discussed above, economic experts on both sides relied on the methods put forth in the federal regulations. These cases follow the same fact patterns and analysis required of the large international cases, and they turned on evaluation of the initial studies performed to support the intercompany pricing. According to the testimony, Hallmark's documentation was significantly more substantial than Lowe's.

The international transfer pricing world is a dynamic environment right now. Countries are introducing regulations for the first time, while more established transfer pricing regimes, like that of the United States, are taking a fresh look at the laws and how they have been used over the last decade. Tax controversy involves higher stakes, and audit scrutiny is prevalent. Even the states are more active in scrutinizing intra- and inter-state activities. Therefore, companies that have intercompany pricing whether just at the state level still need to pay attention to the federal laws and document appropriately.

Endnotes

1 Robert Guy Matthews and Jeanne Whalen, Glaxo Will Settle A US Tax Case for $3.4 Billion, Wall St. J., Sept. 12, 2006, at A1.
2 Merck Settles Tax Case for $2.3 Billion, FDAnews Drug Daily Bulletin, Feb. 23, 2007, available at LEXIS, News & Business Library.
3 26 C.F.R. § 1.482 (2007).
4 N.Y. Comp. Codes R. & Regs. tit. 20, § 6-2.1 (2007).
5 In re Hallmark Marketing Corporation, DTA No. 819956 (N.Y.S. Div. of Tax Appeals Jan. 26, 2006).
6 Id. at 1.
7 Id. at 24.
8 Id. at 2.
9 Id.
10 Id. at 4.
11 Id. at 22.
12 Id. at 7.
13 Id. at 23.
14 Id.
15 Id. at 26.
16 Id. at 27.
17 Id. at 26-27.
18 Id. at 26.
19 In re Lowe's Home Centers, Inc., DTA No. 818411 (N.Y.S. Div. of Tax Appeals Sept. 30, 2004).
20 Id. at 2.
21 Id.
22 Id.
23 Id. at 4.
24 Id.
25 Id. at 7.
26 Id. at 8.
27 Id.
28 Id.
29 Id. at 4.
30 Id.
31 Id. at 10.
32 Id.
33 Id. at 48.
34 Id.
35 Id. at 50.

36 Id. at 56.
37 In re The Sherwin-Williams Company, DTA No. 816712 (N.Y.S. Div. of Tax Appeals June 7, 2001).
38 Id. at 2.
39 Id. at 6.
40 Id. at 115.
41 Id. at 139.
42 In re The Sherwin-Williams Company, DTA No. 816712 (N.Y.S. Div. of Tax Appeals June 5, 2003).
43 Id.
44 In re Sherwin-Williams Co. v. Tax Appeals Trib. Of Dept. of Taxation & Fin. of State of N.Y., 2004 NYSlipOp 07737 (Oct. 28, 2004) at 4.
45 Id. at 3.
46 Id. at 4.
47 Id.

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