IN THE FOURTH JUDICIAL DISTRICT COURT
IN AND FOR UTAH COUNTY, STATE OF UTAH
UTAH STATE TAX COURT CASE

SEE'S CANDIES, INC., Petitioner, vs. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	FINDINGS OF FACT AND CONCLUSIONS OF LAW Case No. 140401556 Judge SAMUEL D. MCVEY

This matter came before the Court on a bench trial *de novo* following a decision by the Utah State Tax Commission in a formal adjudication, *see*, Utah Code Ann. § 59-1-601(1). The adjudication increased petitioner's corporate franchise tax liability by disallowing a deduction (for variety and clarity, the Court also refers to the franchise tax as income tax at times in that it is an income tax). Petitioner ("See's") was represented by Eric S. Tresh, Esq., Jonathan A. Feldman, Esq. and Nathan R. Runyan, Esq. Respondent Auditing Division of the State Tax Commission (the "Commission") was represented by Clark L. Snelson, Esq. and John C. McCarrey, Esq.

There is not much dispute over the underlying facts in the case. They are documented well. Resolution of the issues largely depends on the correct interpretation of Utah Code Annotated section 59-7-113 and which facts are material. The mentioned section is similar to section 482 of the United States Internal Revenue Code ("IRC").

The Commission argues section 59-7-113 is a stand-alone section giving the Commission authority to reallocate income if it concludes in its broad discretion there is a distortion of income for tax purposes or avoidance of income. It contends the Legislature did not intend the statute to involve interpretation by reference to federal IRS regulations. Further it argues even if the section's application is intended to be guided by those regulations, See's cannot meet the "arm's length" transaction standard of the IRS regulations because the parties to the transaction are related and a deal between related entities is by definition not arm's length. These are issues largely of first impression.

See's contends section 59-7-113, being virtually identical to IRC section 482, depends on the IRS regulations for interpretation and application it meets those regulations' requirements for taking the deduction. Further See's argues the Commission's decision was arbitrary because it was not made with reference to any appropriate standard.

Having heard the evidence and arguments of counsel and having reviewed their very professional and thorough proposed findings and conclusions, the Court enters its Findings of Fact and Conclusions of Law.

FINDINGS OF FACT AND STATEMENT OF PROCEDURE

A. The See's - Columbia Transfer

1. See's is a California corporation selling candy in Utah. It has had a physical presence here through its stores for the audit years relevant to this case, January 1, 1999 through December 31, 2007. It also sells candy by catalog order. Since 1972 it has been a wholly-owned subsidiary of Berkshire-Hathaway ("Berkshire"), Warren Buffet's insurance company-based business organization. It files Utah corporate franchise tax returns on its income from sales in Utah. (See's actually files a combined return with See's Candy Shops, Inc. Thus for purposes of this opinion "See's" includes the See's Candy Shops corporation as well.) See's deducts from income royalty payments to Columbia Insurance Company ("Columbia") for use of intellectual property ("IP") Columbia now owns having purchased it from See's in 1997.

2. Columbia, a Nebraska corporation, is also a wholly-owned subsidiary of Berkshire in that another Berkshire subsidiary, BH Columbia, owns all of Columbia's stock. Columbia sells insurance policies in Utah and collects premiums. The State of Utah taxes Columbia's premiums rather than income, as required under the Utah Revenue and Taxation Code for admitted insurance companies. Consequently, Columbia's annual Utah tax liability is in the low double-digits of dollars.

3. Berkshire, the parent of See's and Columbia, has a culture of autonomy for its subsidiaries and allows them to operate independently. This culture is reflected in Berkshire's well-publicized practice of acquiring well-run, financially successful companies and allowing them to operate autonomously. See's and Columbia do not share management.

4. In 1997, Columbia offered to purchase IP from See's as well as other Berkshire subsidiaries in exchange for stock. The IP consisted of trademarks and other intellectual

property. See's eventually accepted the offer as described in more detail below. The stock was to be in BH Columbia, Columbia's parent and another Berkshire subsidiary. The transaction was to be a tax free exchange under section 351 of the federal Internal Revenue Code. ("IRC"). The agreement required consent of See's, Columbia and BH Columbia. The BH Columbia stock was not traded publicly. There would be no restriction on See's selling the BH Columbia stock. See's accepted the offer. Pursuant to a transfer pricing study the value of the IP was assessed and the value of shares exchanged equaled that value. The equal value permitted a tax-free exchange under IRC section 351. The IP and stock values were estimated at about $450 million apiece. At the end of 1997, Columbia and See's memorialized the deal with a non-exclusive license agreement.

5. Under the agreement, Columbia would protect and develop the intellectual property and See's would pay royalties quarterly to license it back. Pursuant to this contract See's has paid royalties each quarter and deducts these payments from its income as business expenses. It retains the Columbia stock which has increased in value over the years. The IP cannot revert to See's under the agreement even if the contract terminated nor can the BH Columbia stock revert back to Columbia. (Prof. Swain, one of the Commission's tax law experts, disputes the value of the stock, claiming it is valueless; but he is not an economist or a Certified Public Accountant. For example, he did not have a complete view of how the market will set a price for the stock under economic principles, not being an economist.)

6. Some other Berkshire subsidiaries made a similar arrangement with Columbia. One subsidiary decided not to participate. Columbia has been actively marketing three other Berkshire companies over the past three years to enter a similar arrangement with it. None of them has taken the offer.

7. Berkshire hired an outside accounting firm, Deloitte Touche to value the See's IP and the Columbia BH stock. The parties desired to ensure the transaction as structured would meet the "arm's length standard" (similar to a fair market value standard concept) for transfers between related parties pursuant to IRC section 482. The goal was to establish a market price and prevent income reallocation of the royalty payments back to See's as taxable income Deloitte concluded the IP value corresponded to the value of the stock. Deloitte also used this valuation in a second study to compute an "arm's length" rate of royalties for use of the IP. "Arm's length" means an objective market value of the IP, using a median of a range of values. The BH Columbia stock was valued using the company surplus divided by the number of authorized preferred shares.

8. Since the agreement, Columbia's surplus and hence the value of the BH Columbia shares, including those owned by See's, have increased. See's IP value has also increased as

measured by the percentage of its sales due to good will reflected in the IP. See's stock has appreciated.

9. Deloitte based its valuation conclusions on an economic and functional analysis of the transfer under the Comparable Profits Method. This is an acceptable means for valuation under Internal Revenue Service rules. It used the same method in updating its report in 2001, concluding a justifiable royalty range for the IP licensing was 17.2 % to 20.5% of See's domestic sales with a median of 19%. It established the arm's length transfer rate that would be paid by unrelated parties under IRC section 482 by adjusting for IP maintenance and development costs to be reimbursed by Columbia to See's. The net royalty rate range was 15.9% to 19.2% with a median rate of 17.7%. See's and Columbia used this rate to confirm the royalty was fair at market value and could be used as a benchmark for negotiating future license agreements. See's economist expert who testified at trial confirmed the accuracy of this assessment.

10. From January 1998 to December 31, 2000 the net IP royalty was set at 16.5% of See's net domestic sales. This rate resulted from an adjustment of the median rate for the 1.5% credit Columbia gave See's for advertising and other IP maintenance such as maintaining the IP through customer subscription lists.

11. In a related agreement, negotiated over the course of several weeks using the transfer pricing report, the parties agreed IP created by See's on Columbia's behalf would be owned by Columbia and licensed to See's. Columbia would reimburse See's development expenses at a .rate of 5% of net domestic sales. This rate was different than those Columbia agreed to in licensing agreements with other companies.

12. The deal was renewed in 2000 for three years, from January 1, 2001 through December 31, 2003. It included the same rates based on the Transfer Pricing Report.

13. According to See's expert Certified Public Accountant, Mr. David Kennedy, who had been involved in many such deals involving transfer of intellectual property and studied this one, and See's expert economist, Dr. Brian Cody, the deal had valid business purposes of the type used by other established companies to justify transfers of IP . Mr Kennedy noted similar transactions often occur between unrelated business entities.

14. After the agreement's term passed, the companies continued to deal with each other on the same conditions through 2007 with See's continuing to take deductions for IP Royalties it paid Columbia. Mr. Kennedy indicated this practice was common and would be expected when

the agreement continued to be mutually beneficial. After the pertinent tax years in this case, a new agreement was negotiated in 2009.

15. The transfer agreement provided Columbia with additional cash reserves so it could issue more policies, which it could not have done without increasing its surplus of reserves.. Since See's was not planning on expanding, the deal allowed See's to deploy excess cash in exchange for stock in a growing Buffett company. The value of the stock appreciated substantially after the deal.

16. The agreement allowed Columbia, an entity with IP expertise, to develop and protect the trademarks and other intellectual assets See's transferred. Before the deal, See's had one non-attorney managing the intellectual property part time. Columbia, had a full time attorney who spent about 75% of his time on the intellectual property. When it rolled out its licensing program and advertised it to related companies, Columbia established an IP team of three attorneys with authority to protect, develop and maintain IP sold to Columbia by See's and other entities.

17. For example, Columbia keeps trademarks in force through the U.S. Patent and Trademark Office and in various states. It has prosecuted infringements against the See's brand and other companies' brands. In this regard, there is value in having an insurance company provide these services since insurers are notorious litigators with great experience. The arrangement also insulates See's from being embroiled in litigation at the risk to vendor relations such as with operators of kiosks and high-end retailers.

18. Columbia's chief IP attorney also visits, trains and regularly calls See's and other companies regarding updates in IP law and best practices. The attorney helps evaluate company procedures regarding how processing quality enhances IP. He provides recommendations to ensure the IP is protected. If Columbia failed in these services and in protecting the IP, Columbia's value would fall as the IP owner. Thus it has a performance incentive. The contract requires See's to report quality issues to Columbia relating to the IP and it does so.

19. The IP is registered at state and federal levels in Columbia's name

20. By outsourcing the IP to Columbia as the purchaser and paying royalties to Columbia to use and protect and maintain the IP, See's can focus on its core business of making and selling candy. A "Plan for Transfer of Intangible Assets" regarding Columbia executed at the time of transfer stated these business purposes and provided Berkshire a more precise determination of its operating companies' (including See's) cost of capital. Separating the IP from operating

companies helped insure Columbia would receive the economic benefits from the IP in perpetuity.

21. In addition, See's got a higher yield on its cash by getting an interest in a higher growth Berkshire insurance company than it would have by holding excess cash in its essentially limited growth business. See's income has also grown.

22. Though the Commission attacked See's expert conclusions regarding proper business purpose on cross examination, it did not provide qualified experts to rebut them. The See's experts maintained their position under fairly withering questioning. The Commission experts were tax lawyers unqualified to address the underlying accounting and economics of transfer pricing or business purposes.

23. The net result of this deal for our purposes is for the tax years in question, See's is trying to deduct from its corporate income millions of dollars nationwide for the payments it makes to Columbia to use the trademarks and other intellectual property. The deduction amount attributable to Utah income is in the range of about $50 to $60 thousand per year. The deductions reduce See's corporate franchise tax assessment about 82% per year for the years audited.

24. Columbia acknowledges the royalty payments it receives are income but since in Utah it is only taxed on premiums it collects, it does not pay income tax on the funds received from See's here. It does pay income tax in states that tax income rather than premiums. Some companies besides See's participate in this IP licensing arrangement with no tax benefit due to state taxing structures. See's reasonably maintains it would continue to participate in the licensing program in states where it receives no tax benefit .

25. Columbia does not return to See's any part of the royalties it receives as payments. It does not give See's loans, dividends or other compensation. Neither party can rescind the transfer under the agreement. Columbia can license or sell the IP to other companies and has licensed it to Mattel before.

26. Utah is a member of the Multistate Tax Commission ("MTC"), a non-governmental organization providing non-binding audits and other guidance to state taxing authorities. The MTC audited See's deduction for 1995 to 1998 and concluded it was proper for various states.

27. For Utah, the MTC recommended approval of the deduction but with a 20% non-business royalty adjustment. The MTC intended the adjustment to represent an increase in Columbia's capital and reflect See's business activities in the State. The MTC made a similar recommendation to other states. Ir suggested Idaho and Oregon allow the entire deduction.

28. The MTC concluded See's makes its payments pursuant to an agreement with a valid business purpose as required by IRC section 361 and not to avoid taxes. The MTC later changed its recommendation to a 10% reduction at the direction of the auditor's supervisor.

29. The states the MTC audited, including Utah, basically accepted the MTC's recommendations with at least one reducing the non-business royalty adjustment and thus See's tax liability. The Commission determined to accept the 10% recommended reduction. (As described below, a current staff attorney for the MTC, Mr. Fort, does not believe the MTC would make a similar recommendation today.)

30. The 10% disallowance appears based on an adjustment of See's royalty rate from 18% to 16.2% which is at the bottom of the acceptable royalty rate range found in the 1997 Transfer Pricing Report.

31. In 2001, the Commission auditors also determined See's was not unitary with Berkshire and must file its own returns. They also determined See's is not unitary with Columbia.

B. The Commission Decision and Procedural Facts

32. The Commission auditors disallowed the royalty deductions for the years 1999-2007 in a 2009 "Statutory Notice" letter:

> The Auditing Division has determined that the shifting of income between Sees and Columbia, an entity not filing Utah corporation franchise tax returns resulted in understatement of the income attributable to the business operations of Sees. At least one other state has examined similar transactions between Berkshire Hathaway subsidiary and Columbia and has made a similar determination resulting in adjustments to the royalty expense deductions of the subsidiary. This transaction is similar, if not identical, to transactions that have been reviewed by a number of state courts and have been held to be invalid or to result in an improper shift of income.

33. The other state referred to was Oregon which in fact did allow 20% of the deduction under its add back statute. Utah does not have an add back statute. Contrary to the letter's position. there were not a number of state court cases but only one in in Oregon, *Pacificare Health Sys., Inc. v. Dep't of Revenue*, 19 Or. Tax 460 (Or. Tax Ct. 2008).

34. The Auditing Division also noted See's and Columbia were related entities, there was less tax remitted than would have been without the deduction and the deducted amount had been earned selling candy. Therefore See's earnings should be subject to being taxed.

35. The auditors also cited to Utah Code Annotated section 59-7-113, discussed extensively *post*, as authority to reallocate income between two corporations to clearly reflect income. The auditors stated in an E100 schedule there was no business purpose for the transfer and stated elsewhere there was no arm's length transaction. The Division did not inquire of See's what the business purpose was. (In response to See's position at trial which included the auditors impliedly acknowledging, relying on, or appearing to rely on federal rules to construe section 59-7-113 when they cited to a lack of business purpose and arm's length transaction, the Commission contends it has discretion under section 113 to redistribute the amounts of the royalties back to See's. It could then ensure See's income is clearly reflected and federal rules of law do not apply when considering redistribution under section 113. Further, in response to See's theory of the case that regulations issued under IRC section 482 allow the deduction, the Commission argues the only limit on the Tax Commission, as an independent constitutional entity, is an abuse of discretion standard.)

36. In administrative proceedings the Tax Commission agreed with its auditors concluding section 59-7-113 precluded shifting of income through royalty payments between See's and Columbia since Columbia does not file Utah corporate franchise tax returns. This "results in an understatement of income attributable to the business operations of See's."

37. The Commission found See's was able to command a premium price for its products in part because of brand loyalty associated with its products. Its activities in Utah remained the same in the years in question after the transfer of its IP. Based on these factors , the Tax Commission imposed a tax of $246,914 with interest of $73,698 for a total liability of $320,612. The Commission argues this adjustment clearly reflects income.

38. The Tax Commission also concluded the royalty deduction would decrease See's taxable income by 75% for the audited years and thus section 59-7-113 justified the disallowance to clearly reflect See's income. The Tax Commission did not evaluate whether the royalty was priced at arm's length or if there was a business purpose. The only potential finding was a statement with no adequate foundation that See's would not have entered such a deal with an unrelated corporation. There was no review of the transaction documents, the Deloitte study, or the nature of the adversarial negotiations between See's and Columbia. (The Commission stated at trial before this Court it was claiming See's was evading tax. It clarified it was not relying on the "evasion of income" prong of 59-7-113 in the sense that See's intentionally took illegal measures to evade income. Rather, using a federal law interpretation , the Commission stated

evasion means the same thing as avoidance so the Commission's decision could rest on this ground listed in section 59-7-113. See's pointed to other states adopting add back statutes. The fact Utah did not have one would prevent it from readjusting income between Columbia and See's. The Commission noted Utah has unitary reporting and would not need an add back statute. However, it has also previously determined See's and Columbia were not a unitary group. Pursuing this add-back path of argument does not seem essential to this Court as it will focus on the meaning of the statute and whether federal guidance should be used in its interpretation when applying it to the facts. Utah does not require insurers to file a combined tax return, has no add back statute and the Legislature has made a policy decision not to tax their income, but rather their premiums.)

39. There was no dispute Columbia owns the IP in question.

40. The Commission's auditing director stated there are no state court decisions where a similar deduction was disallowed in its entirely under similar facts.

40. See's filed a timely petition for review of the Commission's denial of the deduction.

EXPERT OPINIONS

The Court includes expert opinion summaries for background as the case testimony was overwhelmingly from experts. The Court will apply the experts' conclusions later.

The Court under the principles of Rule 702 of the Utah Rules of Evidence does not consider the tax professors and attorney, Professors Pomp and Swain and Mr. Fort respectively, to be experts on the accounting and economics of IP transfers between companies. They are, however, entitled to incorporate the transfer pricing reports and CPA and economist expert conclusions into their opinions as foundation. They also have some familiarity with tax accounting due to their work advising state taxing authorities over the years. The Court is a gatekeeper regarding expert opinions and exercises a rational skepticism when it comes to a question of admitting them. However, the tax professors and attorney are clearly qualified to provide opinions on state taxation law and application of that law to the facts. Professors Pomp and Swain are likewise experts on federal tax law including IRS section 482 regulations. (The Commission also asked these experts to compare foreign inversions to the situation at hand. Though a hot topic on the national and now the EU scene due to disagreement on the cause and economic impact of such events, this Court does not believe that political hot potato really applies to the decision it has to make in this case.)

A.. <u>See's Experts</u>.

See's called three experts: Mr. David Kennedy, a CPA, Dr. Brian Cody, an economist and Professor Richard Pomp, a tax law professor.

1. **Mr. David Kennedy**.

Mr. Kennedy was the only Certified Public Accountant who testified. He talked about the nature of IP transfers between unrelated parties and how common such transfers are, including some in which he had been personally involved. He addressed the business purposes and benefits of such transfers and concluded the transaction in this case had numerous benefits to each party. They would justify such a deal between unrelated parties. He opined there was a proper business purpose of the type required for a deduction under IRC section 162 and the transfer had the hallmarks of an arm's length sale. He evaluated the transfer in this case and concluded it was negotiated and documented in the way two unrelated companies would do so.

The business purposes included See's getting valuable preferred stock in a Warren Buffet company and Columbia receiving cash flow allowing it to write more policies. For See's it also allowed a diversification of risk of unexpected market declines, health scares from the candy product and investment of excess cash. It allowed insulation from litigation and expert IP management. He had heard similar reasons expressed by other IP owners and sellers when he worked on transactions between unrelated parties. He would not have advised See's to undertake such a transaction solely for the tax benefit–he would not let tax impacts drive the deal.

2. **Dr. Brian Cody**.

Dr. Cody was the only economist who testified. He evaluated the 1997 and 2001 Transfer Pricing Reports by Deloitte. He testified many states use transfer pricing to obtain the fair value of goods and services in agreements between related parties. The distinction between transfer pricing and fair market value pricing is transfer pricing is used to test transactions between related entities such as corporations with a common parent as in this case. The best way to apply the principle is to look at similarly situated unrelated parties to find market prices. Then evaluate whether the transfer price can be tied to a market prices. The section 482 regulations control the process. Application of the process to IP in transactions is not uncommon.

Dr. Cody stated the comparable profits method Deloitte used was valid, the best method for appraisal and met the functional analysis requirement of IRC section 482 by seeing what the major value-generating activities of the business consist of–manufacturing and sale in this case. By comparing operating profit to sales then subtracting the activity from routine activities the report was able to figure the value of the IP then come up with a median royalty rate. The rate is a market rate on which parties could agree. The process is at bottom an appraisal.

Dr. Cody stated the purpose of transfer pricing evaluation is to ensure transactions between related parties reflect fair market pricing. The practice and has a long history in sales and in application of IRC section 482. Dr. Cody has extensive experience in such studies. For the audit years, he opined the valuation of the transferred IP was based on sound transfer pricing principles underlying market price. On this basis, the royalty rate See's paid Columbia was in the arm's length range of royalty rates specified in the Deloitte studies. Also, the MTC audit's recommendation the royalty deduction be reduced 10% was within this range.

Dr. Cody testified evaluating sale and licensing of IP is one of the most common inter-company deals he has seen in 25 years of practice in the field. He concluded the transaction in this case reflected fair market pricing. In his opinion the transfer pricing was based on standard valuation principles and established a reasonable range of royalty rates, which satisfies the IRC section 482 transfer pricing regulations. The royalties amount See's pays is justified by the premium prices the See's brand, or IP, commands. The royalty rates would be what unrelated companies would negotiate on similar facts. The 2001 Transfer pricing report confirmed the 1997 report used to justify the initial transfer. Further, the 10% reduction recommended in the MTC audit was reasonable because it fell at the bottom of the arm's length royalty range established in Transfer Pricing Reports. The credit Columbia gave See's for maintaining IP and developing it through advertising and similar activities would be reasonable under the same analysis.

3. **Professor Richard Pomp**.

Prof. Pomp is a law professor who teaches and advises on state tax law. He has experience advising and testifying on Utah tax law. He has consulted and trained for the MTC and has been a MTC hearing officer. As with the Commission's law experts, the Court only considers Prof. Pomp's opinions on the law and will rely on the CPA business expert and economics expert for reasonableness of valuation of the transfer itself.

Prof. Pomp compared section 59-7-113 to IRC section 482, pointing to their nearly identical language. He noted the purpose of section 482 is to put transactions between related parties on the same footing as if they took place between unrelated parties. The process involves examining whether the sale has a business purpose for a deduction under IRC section 162 and the transfer price is arm's length. He stated section 482 allows taxing authorities to make this evaluation. Other states with a statute similar to sections 59-7-113 and 482 use such evaluations. Utah has implicitly adopted IRC section 162 because the starting point of Utah corporate income tax is federal taxable income which takes into account business expense deductions under section 162. Federal taxable income provides the definition of Utah unadjusted income (later adjusted mainly by taking out federal taxes paid). Otherwise, we would see a gross receipt tax.

Prof. Pomp testified See's should pay Columbia an arm's length royalty consistent with Dr. Cody's testimony, which he heard, and the Deloitte study. Further, denying that deduction for the cost of doing business would distort the calculation of See's income by ignoring all of its payments. Further, the Commission's proper remedy if it felt there was not arm's length pricing would be to make an adjustment to reflect such a pricing rather than disallowing the whole deduction.

Prof. Pomp noted many other states have adopted statutes which, like section 59-7-113, are virtually identical to IRC section 482. Others refer to the IRC thus implicitly adopting section 482. Every state with a legitimate state income tax must give a section 162 deduction for ordinary and necessary business expenses or they do not have a true income tax. Utah has adopted such a deduction, indicating the need for a 482 analysis for transfers.

Prof. Pomp opined failure of the Tax Commission even to address business purpose and arm's length in administrative proceedings and the Commission's position at trial that a transfer between related parties is not only presumptively but by definition less than arm's length was arbitrary and capricious. The Commission simply exercised unfettered discretion to reach its decision unguided by any reasonable standard. He also concluded the MTC audits were legally justified and based on application of appropriate regulatory limits of discretion exercised by taxing authorities. The fact the auditing division director testified there was a limited review of the arm's length nature of the transaction did not save the Commission in Prof. Pomp's opinion because its ultimate decision was there could be no arm's length transaction because the parties were affiliated. He thought since the Commission made no effort to evaluate anything as compared to the MTC audit which did, it only performed a "desk audit" checking math of total sales and correct entry of numbers A legally valid audit would evaluate business purpose and arm's length price. It did not evaluate of the Deloitte studies.

Prof. Pomp also distinguished the cases the Commission relied on as merely superficially similar to See's situation. They dealt with transactions where: 1) there was a prearranged sale to third parties without booking the income, 2) the involved state had an add-back statute or combined reporting which Utah does not, 3) the transferee was a shell company without employees or an office, 4) the insurance company transferee was a captive company or 5) there was some other effort showing the primary purpose of the transfer was tax evasion. In other words, there was no legitimate business purpose.

He observed in the present case Columbia is a substantial business with numerous employees and a real headquarters.   There was no add back or applicable combined reporting requirement. The section 351 transfer value of the royalty was unchallenged –the Commission provided no witness qualified to dispute the transfer value-and thus there was a legitimate cost of doing business for See's. In the other cases the IRS or state agency challenged legitimacy of the 351 exchange.

Prof. Pomp disagreed with the Commission's position section 59-7-113 creates a presumption or definition that related entity transfers are not arm's length. Such an interpretation would give the Commission unfettered authority to disapprove a deduction. It would be unprecedented and not good tax policy as it promotes arbitrariness.   It also ignores other states' practice of applying section 482 regulations. There is no good reason states would want to duplicate that ext4ensive rule-making work and create their own regulations. He also stated the Commission gave conflicting reasons for disallowing the deduction because the interrogatory answers before this Court were different than those offered in the administrative proceeding. (There were some differences.) He believed it contrary to the rule of law for states to offer shifting reasons for denials as taxpayers need to have notice of standards so they can plan.

Prof. Pomp noted there was fastidious compliance with section 351. The MTC audit carefully scrutinized the transaction and found no significant problems. The transaction would have occurred in a world without taxes. (However, the Court notes in connection to all of See's experts, the tax savings value to Berkshire of tens of thousands of dollars per year could certainly seem incentive enough for See's to undertake the deal for tax purposes. Also, even though Berkshire recognizes See's independence, it was aware of the transfer, and provided the Deloitte study creating suspicion of a principle tax motive.)

B. <u>The Commission's Experts</u>

The Commission called two experts: Mr. Bruce Fort is a tax attorney and Professor Jonathan Swain is a tax law professor.

1. **Mr. Fort**.

Mr. Fort has been counsel for the MTC since 2007. He was in private practice before that. He teaches state tax law to state tax departments and at law schools. He writes briefs and reviews MTC audits. He is not an expert on IRC section 482.

Mr. Fort testified a review of the underlying transaction and an audit would be relevant before an auditor disallowed a deduction.   Also Utah does allow taxpayers to deduct ordinary and necessary business expenses as defined by IRC section 162. However, he believed section 59-7-113 did not incorporate the interpretations given under federal law to IRC section 482. He opined the Utah Supreme Court's opinion in the *Continental Telephone* case established this point. (*Continental Telephone Co. of Utah v. Utah State Tax Comm'n,* 539 P. 2d 447 (Utah 1975). He indicated there is litigation in New York on the issue of whether the taxpayer rebutted the presumption of distortion that arises from a non-arm's length transaction. By "non arm's length" he means it in "the sense that Utah has used it–a transaction between two related parties." He cited the *Pacificare* and other state cases as well.

He stated the whole point of the Uniform Division of Income for Tax Purposes Act ("UDIPTA") which Utah was using at the time of the audit years is states do not believe in arm's length accounting. Rather, they look at the property, payroll and sales compared to those elsewhere under the principle one cannot divide out parts of an integrated operation. Utah adopted most of UDIPTA during the years in question but has departed significantly from it since.

Mr. Fort testified unlike the IRS, states under UDIPTA use a unitary principle where they put all money made in the country into a combined basis then evaluate how much of that was generated in the state. Since the IP is integral to See's ability to conduct business, it must be included under this unitary principle. He believes using section 59-7-113 would not have occurred to the MTC auditors and Utah could combine the entities here to prevent distortion, notwithstanding the Commission having found See's and Columbia were not unitary. There is a presumption of distortion where an entity with large income and little property and sales is unitary with one that has virtually no income, and a lot of property, payroll and sales. Thus, he did not believe the MTC advisory audit would be acceptable today.

Mr. Fort opined everything in the IRC is already part of Utah's tax laws, but section 59-7-113 was adopted separately from the IRC. His main problem with Prof. Pomp is the professor ignored the unitary business principle. He believes Prof. Pomp overlooks a unitary asset being used to generate revenue in Utah but is only subject to a small amount of tax. Prof. Pomp focuses on the IRC but not on section 113 which is directed to unitary businesses. (Here the Court must note the Commission is not saying See's is unitary with other businesses and actually stated otherwise in the administrative proceedings. It is merely stating it has discretion under section 113 to prevent distortions without reference to other statutes. In fact, the auditing division previously stated the transaction parties were not unitary and its director, Ms. Newsom, confirmed this point at trial.)

Mr. Fort attempted to reconstruct the Commission's decision by justifying the deduction as one in a unitary tax base. However, there is no evidence of the Tax Commission making such an effort. He did acknowledge the Commission determined See's should not file a combined return with the larger Berkshire group. He also testified it would not be an abuse of discretion for the Commission to use arm's length analysis; there would also be no abuse to recombine a unitary asset and deny the deduction under proper aligning of income and expenses.

He noted distinctions in other states' cases he was relying on for not allowing arm's length and acknowledged the unitary principle would not apply to insurance companies in Utah. He also agreed one reason the Commission denied the deduction is it believed there was no business purpose. He agreed the Commission has not alleged the IP was owned by any company other than Columbia and with the transfer Columbia has a new revenue stream on which to write insurance.

2. **Prof. Swain**

Prof. Swain teaches tax law, has been active in developing state tax procedures and writes on the subject. He opined See's deduction distorted its Utah income. Columbia's gain on the royalty payments it received and See's gains from selling the IP would never be taxed because they would be deferred indefinitely. There had already been 20 years of deferral. There is no reason for See's ever to sell the stock and realize the gain. It would only do so if it wanted a third party investor involved and in that event it would simply issue new stock at no tax cost. (He did not address the stock value dilution per share this may cause and potential shareholder and director resistance to such a dilution.) Also, by Berkshire breaking down the company into layers dealing with each other there are layers of gain but no taxable transactions due to the Utah premium tax.

Further, any distribution would be through liquidating the assets of BH Columbia, the holding company, and See's BH Columbia stock would disappear in a non-taxed scenario. Berkshire would always own 100 per cent of Columbia resulting in no transaction to trigger tax accountability due to transfers to an insurance company. There would only be movement of property in exchange for stock within the corporate group, again deferring all gain. Such an exchange would be allowed under IRC section 351 but Utah should not recognize it for tax purposes.

Prof. Swain believes Section 39-7-113 is a backstop to fix these overall problems. It would be irrational not to recognize such gain each year. (Of course, if such a string of events occurred, the Court believes there may be questions from tax audits about whether the transfer was made for the primary purpose of avoiding taxes rather than a business purpose. It would be on a much larger scale than what we are witnessing here and would have to involve See's co-opting an independent accounting firm in the process. The hypothetical is interesting, but not persuasive as Prof. Swain is not an economist or business expert, as he acknowledged. He had no experience operating a business such as See's. The Court did allow his description on economic incentives and for the result taxation is intended to produce. However, he is not qualified to value transfers or appraise company value.)

Prof. Swain testified having a business purpose and arm's length transaction would not change anything–indefinite deferral of tax is still there. He acknowledged if the State taxed Columbia's income, it would take care of the tax avoidance problem..

He acknowledged Utah incorporates IRC section 351 exchanges in its tax scheme which allows deferral of taxable gains when property is exchanged for stock. It adopts IRC section 162 which allows business expense deductions. However, the Tax Commission has broad discretion to disallow such deductions under section 59-7-113 to clearly reflect actual income. He opined the section was a "stand alone" statute allowing the Commission to decide whether income was distorted.

Prof. Swain invoked federal law to justify adding back the royalty payments to See's income and indicated the Commission followed this tack under section 59-7-113 to reallocate income among related parties. The Commission had broad authority under that section to reallocate deductions back to the taxpayer. There is an equitable argument the transfer gave See's an unfair advantage over candy companies not affiliated with an insurance company. (The commission does not seem to rely on this argument.)

He also opined the Legislature "adopted 113 and it looks like they've incorporated 482 as well . . ." But he believed the IRC section 482 regulations permit overriding of gain-deferred transactions made under IRC section 351. The transaction would be looked at the same as a pre-arranged transaction where gain would be allocated tax-free back to the transferor.

Prof. Swain stated striking the deduction would not go against the premium-tax statute because companies that pay sales tax also pay income tax. Thus it should not matter if Columbia is subject to another tax regime through its affiliate. (Of course, the Court notes those sales-taxed companies are not exempt from income tax like an admitted insurer is.) He believes Columbia was simply used by a taxable entity like See's as a vehicle to avoid tax.

Finally, as to evidence See's sold and licensed back its transportation assets to a taxable third-party in a section 351 exchange and did not limit such sales to companies paying no income tax, Prof. Swain pointed out the difference is if the transportation license expires See's can always get other transportation. If the IP trademarks expire, See's cannot get other trademarks. This difference makes the latter an invalid transaction for tax shifting purposes.

C. **Rebuttal by See's Experts**

Needless to say, See's experts disagreed with those of the Commission. Dr. Cody disagreed with Prf. Swain's view of the effect of IRC section 482. The purpose of section 351 is to defer gain but there must be a legitimate valuation of the transfer. It cannot just be any value. Thus the deferral is protected. The value goes on the corporate balance sheet and as in any other 351 exchange crystallizes future gain.

Prof. Pomp noted the *Pacificare* case was inapposite as there were strings attached to the transaction and the transferee did not own the property. In the other cases the Commission cited the purpose of the transfer was to avoid tax and there was no legitimate business purpose. The key is whether there is a business purpose and arm's length pricing. Further, he opined Prof. Swain's approach was aspirational to maximize taxes without complete application of the law. He stated Prof. Swain did not mention the prearranged transfer cases cited in Prof. Pop's testimony whose facts demonstrated what such a transfer was and how it differed from this case. Unlike cases the Commission relies upon, there is no agreement here Columbia would immediately sell the IP and the Commission has not challenged the application of IRC section 351 to this case as did the IRS and state authorities in the prearranged transfer cases.

Also, Prof. Pomp believed the United States Supreme Court would not allow Mr. Fort's "novel theory" to apply to See's and an asset it did not own. He stated Mr. Fort confused this case with a unitary deduction case whereas the Commission previously stated there was no unitary relationship here.

DISCUSSION

This trial in this case was *de novo*. The Commission's administrative findings and decision do not bind the Court. However, they are relevant because they are largely the same points upon which the Commission now relies for its position the Tax Commission was justified by statute in disallowing the royalties-paid deduction. Having made findings, the Court now applies what everyone agrees is the controlling statute in this case, Utah Code Ann. § 59-7-113, to the facts to determine whether to allow or disallow See's claimed deduction.

The statute allows the Commission to distribute income between entities under certain conditions. The primary dispute between the parties over statutory interpretation is whether the legislature incorporated federal tax provisions when it enacted section 59-7-113. The federal rules would support the deduction. There has been no judicial interpretation of this statute on the precise point presented. There is a Utah Supreme Court case addressing it on another point. There is also a non-binding but potentially persuasive Informal Utah Attorney General opinion on the effect of federal law on the Utah statute as discussed below. Thus, this Court must determine in the first instance whether to use federal law to interpret the statute and how the statute applies to the facts of this case.

A. Standard

In construing section 59-7-113 the Court follows the well-established principle of statutory construction, "we need not look beyond the plain language of [a] provision unless we find some ambiguity in it." *In re Worthen*, 926 P.2d 853, 866 (Utah 1996) (citing *Schurtz v. BMW of N. Am., Inc.*, 814 P.2d 1108, 1112 (Utah 1991)). Further, "[w]hile the general rule as to taxing statutes is that they are construed strictly against the taxing authority and favorably to the taxpayer, the reverse is true as to provisions allowing deductions." *Continental Telephone Co. Of Utah v. State Tax Com'n of Utah*, 539 P.2d 447, 450 (Utah 1975). *C.f.*, Utah Code Ann. *§ 59-1-1417(b); Dick Simon Trucking, Inc. v. Utah State Tax Comm'n*, 2004 UT 11 ¶ 5 (quoting *SF Phosphates Ltd. v. Auditing Div., Utah State Tax Comm'n*, 972 P.2d 384, 386 (Utah 1998)); *see also Hales Sand & Gravel, Inc. v. Audit Div. of the State Tax Comm'n*, 842 P.2d 887, 890-91 (Utah 1992))(applying the same rule to exemptions).

With deductions being subject to the same rule of construction as exemptions, the rule of law is where there is ambiguity in the statute, "[a]ny doubt about the proper application of a . . . tax exemption must be resolved against" the taxpayer. *Dick Simon Trucking, Inc.* 2004 UT 11 ¶ 5. Thus, the Court resolves any ambiguity against See's. However while a deduction is so construed it should also be construed "with sufficient latitude to accomplish the [deduction's] intended purpose." *Eaton Kenway, Inc. v. Auditing Div. Of Utah State tax* Comm'n, 906 P.2d 882, 886 (Utah 1995); *see also Hales Sand & Gravel, Inc. v. Audit Div.*, 842 P.2d 887, 890 (Utah 1992); *Utah County v. Intermountain Health Care*, 725 P.2d 1357, 1359 (Utah 1986). The taxpayer has the burden of showing its deduction is fairly and clearly allowable under the statute, *Continental Telephone Co., supra*, at 450.

B. Plain Language of the Statute.

In interpreting unambiguous statutes, Utah courts "assume[ ] that each term in the statute was used advisedly; thus the statutory words are read literally, unless such a reading is unreasonably confused or inoperable." *Savage Indus., Inc. v. Utah State Tax Comm'n*, 811 P.2d 664, 670 (Utah 1991) (footnote omitted). Thus, each term "should be interpreted and applied according to its usually accepted meaning, where the ordinary meaning of the term results in an application that is neither unreasonably confused, inoperable, nor in blatant contradiction of the express purpose of the statute." *Morton Int'l, Inc. v. Utah State Tax Comm'n*, 814 P.2d 581, 590 (Utah 1991) (footnote omitted).

The current Utah Code Annotated section 59-7-113 provides:

> **§ 59-7-113 Allocation of income and deductions between several corporations controlled by same interests.**
>
> If two or more corporations (whether or not organized or doing business in this state, and whether or not affiliated) are owned or controlled directly or indirectly by the same interests, the commission is authorized to distribute, apportion, or allocate gross income or deductions between or among such corporations, if it determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such corporations.

This text appears to be unambiguous regarding the Tax Commission's ability to redistribute deductions if necessary to clearly reflect income. However, it is less clear regarding conditions that should exist before it undertakes that task. Since the language should be construed strictly with respect to deductions, the Commission is arguing the only standard to be applied is "abuse of discretion." One might argue the provision is vague on that point since the only inherent control on discretion for our purposes is to allow it if tax evasion of an illegal nature is taking place. The statute does not say what must happen if the Tax Commission thinks it is necessary to disregard the general definition of taxable income to reach a defensible redistribution clearly reflecting income. But the provision does give the Commission authority to adjust deductions for that purpose after a transfer between corporations owned by a common parent which transfer results in a deduction. On the other hand, the manner in which it should be applied by the Commission to direct or indirect corporate affiliates has been described as being subject to some uncertainty, *Continental Telephone, supra,* 539 P.2d at 451. In that instance, application of the statute should be viewed "in light of the condition and necessities which [it is] intended to meet and the objects sought ro be attained thereby." *Id*. Where the Commission is suggesting it enjoys broad discretion to adjust income, and it undoubtedly does, there should be some law to guide how its discretion should operate in getting deductions to clearly reflect income.

A grant of discretion to the Commission is not unlimited because its authority can only be exercised as established by the Legislature; it cannot redefine statutes or pick which ones to apply to the exclusion of others having bearing on the question, even as a constitutionally recognized entity. *See*, UTAH STATE CONSTITUTION, Art. XIII § 6(4). It does have authority to supervise administration of tax laws, *id., Continental Telephone, supra*, at 450, but must still do it in the manner the Legislature intends. The Tax Commission's constitutional powers are implemented by statute, *id*. The statute itself gives no clear directive on how the Commission is to go about apportioning deductions to reflect income of related corporations. Nor has the Commission identified any administrative rules it has promulgated in aid of this task. Thus, a key question is whether the section in question can stand on its own or whether it incorporates some other direction. This would include whether it borrows the process of IRC section 482 to determine if federal rules issued under that fraternal twin to Utah Code Annotated section 59-7-113 protect See's deduction as arising from an arm's length transaction. This examination will require looking at the Utah section in the context of the statutory scheme, but before doing so a review of how the Supreme Court has read it is helpful.

IRC section 482 provides:

> **26 U.S.C. §482. Allocation of income and deductions among taxpayers**.
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The parties acknowledge this statute is almost identical to Utah Code Annotated section 59-7-113 with the only real difference being the federal law refers to "organizations, trades or businesses" whether or not incorporated while the Utah law refers to "corporations." The federal statute is accompanied by a host of federal regulations explaining how it is to be applied with respect to distribution of income for tax purposes. The framework for addressing whether deductions as business expenses resulting from transfers or payments between related corporations is rooted in whether the transaction was arm's length. "In determining the true taxable income for a controlled taxpayer [under IRC section 482], the standard to be applied in every case is that of a taxpayer dealing at arms length with an uncontrolled taxpayer." Treasury Reg. Section 1.482(b)(1). A controlling legal question in this case will be whether section 482 has any involvement.

C. Application of Federal Rules *and Continental Telephone*

The Commission representative acknowledged the starting point for a corporation's Utah taxable income is federal taxable income. However, the Commission argues the Utah Supreme Court has already held the Commission is not bound by federal interpretation of and rules implementing federal IRC section 482 when interpreting Utah section 59-7-113. The Commission contends the issue is settled in its favor by the Utah Supreme Court's *Continental* ruling. The Commission asserts based on that Utah case, section 59-7-113 is a free-standing provision the Commission can use to adjust income without regard to any other law, particularly the virtually identical federal IRC section 482 and the federal regulations accompanying it. See's argues federal regulations under a similar federal statute must apply or else there is no limit on the Tax Commission's actions.

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Both parties cite *Continental Telephone*, *supra*, 589 P.2d 447, as supporting their respective positions. A fairly extensive rendition of the facts in that case is necessary to appreciate the case's ruling.

In *Continental*, two Utah subsidiaries of Continental Telephone filed Utah state tax returns. They deducted payments they transferred to Continental to help pay its and all of its subsidiaries' federal tax liability under a consolidated return. Continental used the funds to cover preparation of several years of consolidated federal tax returns and make tax payments to the Federal Treasury. It diverted, however, some funds to other subsidiaries to offset losses.

Federal law allowed Continental's consolidated federal return. Continental prepared a return for it and its subsidiaries on a "separate company" basis with Continental dealing with the Internal Revenue Service for each subsidiary. Continental paid all federal tax liability on a consolidated basis. As part of the consolidated process, each Utah subsidiary computed its taxable income and federal taxes separately and forwarded the payments to Continental. The payments were in real dollars delivered to Continental and were not merely accounting entries.

Continental received the payments from the Utah companies along with those of its other profitable subsidiaries. It applied profits from some subsidiaries against losses for others, reducing its overall combined income for federal tax purposes. As mentioned, this was legal for federal returns. Then-current federal law allowed an economically related group of corporations to combine their gain or loss on inter-company transactions. Some gains of profitable companies could therefore be eliminated by offsetting them against others' losses.

As it turned out, the net amount due the I.R.S. under the consolidated return was less than the sum of tax payments its subsidiaries sent in because some of the other subsidiaries had big operating losses deducted from consolidated income; the income of the consolidated Continental group actually totaled less than the incomes reported by the profit-making subsidiaries, including the two Utah companies. Some of the tax money, as traced, went to offset losses and did not make it to the IRS.

The Utah State Tax Commission did not allow deduction on the separate Utah tax returns of all the subsidiaries's payments. The Commission arrived at what it considered to be an equitable adjustment of the tax deduction by allowing it only on the ratio the federal income each profit-producing subsidiary bore to the total taxable income of all profit producing subsidiaries. This resulted in assessed deficiencies of thousands of. The Commission relied on then-numbered section 59-13-17–now 59-7-113-- for authority to disallow deductions to clearly reflect income. (For convenience the Court will refer to section 59-13-17 under its current number–59-7-113.)

Utah Supreme Court looked at the Commission's authority to make adjustments under section 59-7-113. It discussed the subsidiaries' attempt to justify their procedure by comparing federal administrative and court rulings on corporate taxation, including federal cases construing IRC section 482. The subsidiaries noted that section was essentially the same in wording as Utah Code Annotated section 59-7-113. They argued federal courts interpret section 482 to permit only reallocation and not disallowance of deductions among various member of an affiliated group. Federal courts required disallowance of deductions to proceed under IRC section 269 which applies to transactions whose primary purpose is to avoid taxes.

The Supreme Court stated the

> broad wording of Section [59-7-113] indicates a legislative intent to cover all situations dealing with either direct or indirect corporate affiliates without regard to whether they file individual state or consolidated state . . . returns; and that the language of that section authorizes the Tax Commission to so apportion income and deductions of corporations within such controlled groups as to fairly and equitably reflect the income earned in Utah.

Continental Telephone, *supra*, 539 P.2d at 450.

The Court ultimately determined the payments going to unprofitable subsidiaries could not fall in the category of "taxes paid" for purposes of a qualifying deduction. In fact, the Court refined the phrase to "*federal* taxes paid," *id*. (emphasis added), in explaining the funds would have to be deposited in the federal treasury to be deductible. Since they went to another company they did not fall in the definition of the quoted phrases, even though the intent behind paying them was to help with federal taxes. The Court disallowed the part of the deduction that never went to the IRS.

Neither the phrase "taxes paid" nor the expansion "federal taxes paid appeared in 59-7-113. Rather, the Court borrowed the former from a neighboring Utah Code Annotated section. The latter phrase was necessarily expanded to recognize Utah tax statutes refer to the federal IRC in defining much of what controls and is income tax law for the State, and therefore what kind of tax payments constituted "taxes paid.".

Can *Continental* be distinguished from the facts and law in this case? See's thinks so. See's notes only part of the deduction was disallowed where as here the entire amount was denied. See's was fine with a downward adjustment of the deduction by 10-20% as suggested in the Multistate Tax Commission audit, although it was never precise on where those percentages came from. Dr. Cody was able to reconstruct a plausible explanation.

See's also states the Supreme Court in *Continental* did not decline to follow federal precedent interpreting IRC section 482 as the Commission states. Rather, the Court refused to adopt the view that IRC section 482 and the similar Utah law could only be applied to reallocate a deduction from one related entity to another on the facts of the case because the IRS used a different section, IRC section 269, for that purpose. Therefore, section 482 could not be used to adjust a deduction like the Commission did in that case. The IRS does use section 482 to deal with facts such as those in this matter. See's further contends *Continental* does not say section 59-7-113 gives the Commission unlimited authority to disregard any transaction between related corporations simply due to common ownership. There must be a limit or else there is no Rule of Law.

The Commission believes *Continental*, to be right on point in recognizing broad authority in the tax authority to reallocate income. The Commission argues this means the only limit on its authority is an abuse of discretion standard since section 59-7-113 is a stand alone statute. Also, it asserts the Supreme Court in that case expressly stated federal IRC section 482 regulations could not be used to interpret 59-7-113.

Had the companies in *Continental* not been owned by the same business, there would have been no consolidated return and thus no ground for a claimed deduction for taxes paid to another company as a pass-through item. In the instant case, as acknowledged by the Commission's expert, if See's made royalty payments to an unaffiliated rather than another Berkshire company it would get the deduction. Unlike the situation in *Continental*, all the royalties here went to Columbia and none were diverted to other companies to make up losses or for other purposes.

This Court believes reading *Continental* to reject all use of federal authority to apply section 59-7-113 goes too far. For our interests, the Court did not find unbridled equitable power in the Tax Commission to reallocate income between parties under section 59-7-113. Rather, the Court looked outside the statute to the definition of federal "taxes paid." which, as noted, does not appear in section 59-7-113 but is in a different statute The phrase meant amounts actually sent to the I.R.S. and not funds transferred to loss-incurring corporations in another state. Therefore it would be within the prerogative and duty of the Utah State Tax Commission to reapportion the amount of "federal taxes paid" to reflect the amount of taxes actually deposited with the U.S. Treasury. However, this was not a result of 59-7-113 being a stand-alone statute. The Court found it necessary to measure the Tax Commission's exercise of discretion by looking outside to another provision, which must be read in the context of federal law to understand what taxes paid meant. If the Court thought section 59-7-113 gave unfettered discretion to the Commission to apportion income equitably, one would think it would have said so rather than looking elsewhere to the "taxes paid" provision to justify disapproval of the subsidiaries' deduction..

The approach of the High Court fits in with a principle: even unambiguous statutes must be read in the context of the entire statutory scheme. (*State v. Maestas*,, 2002 UT 123, ¶54, 63 P.3d 62. ("A statute is passed as a whole and not in parts or sections and is animated by one general purpose and intent. Consequently, each part or section should be construed in connection with every other part or section so as to produce a harmonious whole.") *quoting* Singer, 2A Sutherland, Statutory Construction, §96:05 (4th Ed. 1984)). However, this principle does not necessarily invite reference to federal law. It only expands examination of the statute beyond its four corners to consideration of other tax statutes. Further, the *Continental* Court stated, with respect to 59-7-113, "Where there is doubt or uncertainty concerning the interpretation and application of statutes, they should be viewed in light of the condition and necessities which they are intended to meet and the objects sought to be attained thereby." *Id.* at 451. This may indicate the Supreme Court did not think 59-7-113 was a stand-alone statute.

See's is not arguing as did the taxpayers in *Continental* that the similar federal statute is inapplicable and a totally distinct federal law should advise application of the state statute subsidiaries. It is stating the Legislature would have intended the state statute's use to be guided by identical federal law because there is no amplification in section 59-7-113 of how it should be applied to facts in this matter. Whether the above distinctions are persuasive requires further discussion.

D. Looking at the Statute in Context of Related Provisions and Subject Matter Laws

As did the Supreme Court in *Continental Telephone*, this Court looks at the statute in context of the other corporate franchise tax legislation. (*See*, *State v. Maestas*,, supra, 2002 UT at ¶54). For example, in this case there are as definitions elsewhere of terms used but undefined in section 59-7-113 such as those of "affiliated" groups, "corporation," "income" and "doing business" (§ 59-7-101, *passim*). The chapter the relevant statute belongs to also exempts from income tax Admitted Insurers such as Columbia whose premiums are taxed under title 59, Chapter 9 (§ 59-7-102(c)), thus raising a question of whether insurance company income can be reallocated back to a sister corporation. (The answer to this question is it probably can be at least to avoid tax evasion arising from a suspicions transaction.)

Also, the term “deductions” is not defined uniquely by Utah statute but rather section 59-7-106 largely defines subtractions from unadjusted income by reference to federal tax law. In terms of commercial income taxes the Utah Code defines "Adjusted income" in section 59-7-101, as "unadjusted income as modified by Sections 59-7-105 and 59-7-106." It states notes in subsection 18 of 59-7-101 that "income" includes losses. Subsection 29 defines “Unadjusted Income” as “federal taxable income as determined on a separate return basis before intercompany eliminations as determined by the Internal Revenue Code, before the net operating loss deduction and special deductions for dividends received.” Sections 59-7-105 and 59-7-106 specify additions and subtractions, respectively, from federal taxable income result in adjusted Utah income.

All of these provisions reflect a close interaction between state and federal income tax laws. In fact, Prof. Pomp and the Commission’s experts recognized Utah has incorporated the IRC. The Commission’s experts just argue the Legislature left section 59-7-113 out of federal influence by adopting it separately. This argument has its failings since the franchise tax sections of the Utah Revenue and Taxation Code in its Chapter 7 surround 59-7-113 in the same chapter, there is more than one section, they are comparable in old age to 59-7-113 and they involve federal tax law. Finally, it is not lost on this Court that the Commission itself is relying on federal case law interpreting the Internal Revenue Code for the proposition “that in this context, evasion and avoidance are used synonymously. . . . While *Continental Telephone* does not speak directly to this point, there is nothing to indicate any intent to deviate from the federal interpretation of [section 59-7-113]’s language on this point.” (See Commission’s Proposed Findings of Fact, ¶ 26.) [1]

E. Informal Attorney General Opinion

In 1979 the Utah Attorney General issued an informal opinion to the Commission. The opinion concluded the Legislature made an affirmative determination it would adopt federal interpretations on the topic of allocation of income under Utah Code Annotated section 59-12-17,

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[1]The Commission also presented a fairly ingenious argument that arm’s length is actually defined elsewhere in the Utah Code Annotated to preclude transactions between related parties. This is true. However, that definition is not in the franchise tax law but a couple of chapters away in the Severance Tax sections at Utah Code Annotated §59-5-103.1. That section has nothing to do with income tax and applies to a specific circumstance–well-head pricing of oil sales.

the earlier version of section 59-7-113. Since the opinion, the section has only been modified by numbering and stylistic changes. The legislature has not modified the section in response to the Opinion.

After indicating in response to a Tax Commission member's question that a certain section of the Revenue and Taxation Code was not available to tax corporate income, an assistant attorney general provided the opinion. The relevant part of the opinion is worth quoting in its entirety:

> However, having concluded that federal 'Sub-part F income' law is not available for use in the Utah State taxing scheme does not rule out the possibility of a U.S. shareholder that is a corporation subject to the Utah Corporation Franchise or Income Tax provisions being taxed upon the income which meets the I.R.C. definition of 'Sub-part F income' under different taxing provisions.
>
> Found within the Internal Revenue Code is a provision entitled 'Allocation of Income and Deductions among Taxpayers.' It provides as follows:
>
>> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. I.R.C. § 482.
>
> In enacting this statute Congress evidently felt that some corporations, which supposedly were separate entites on paper, were actually portions of one large system or network, and were so closely related in ownership, direction, etc. that they should be considered as one corporation for taxation purposes so that their income was 'clearly reflected' so as to prevent tax evasion.
>
> Utah adopted its Corporation Franchise Tax and patterned a similar provision after § 482 when its legislature passed U.C.A. § 59–12–17 [now 59-7-113], which reads:
>
>>> In any case of two or more corporations (whether or not organized or doing business in this state, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the tax commission is authorized to distribute, apportion or allocate gross income or deductions between or

> among such corporations, if it determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such corporations.
>
> In adopting this language, Utah made an affirmative determination that it would adopt federal interpretation on the subject. So, it is my opinion that if a Utah corporation is so closely associated with a foreign corporation, so as to make the distinction between them fuzzy and unclear, then, Utah may allocate income and deduction among these corporations to more clearly reflect their gross income and to prevent tax evasion through use of a foreign associate corporation. Having so concluded, we also advise that the State Tax Commission may look to I.R.S. rulings and regulations and any appropriate case law for interpretations of this section. This is largely a fact question which must be reviewed on a case by case basis.

Office of the Attorney General, State of Utah, Informal Opinion No. 79–214 (December 5, 1979), 1979 WL 32559 (Utah A.G.).

Utah Code Annotated section 67-5-1(7) authorizes the Office of the Attorney General to provide legal opinions to state agencies. In practice, the Office provides Formal Opinions and Informal Opinions. The citation for the opinion just cited indicates it is an informal opinion. The Utah Supreme Court's Law Library Research Guide explains the difference between formal and informal opinions: "Formal opinions, while written by attorneys within the Attorney General's Office, undergo scrutiny at several levels within the office. Once approved by the Attorney General, these are published and released as the official opinion of the Office rather than simply legal advice. . . ." Research Guide: Utah Attorney General Materials Rev. February 2007, © Utah State Law Library.

" Unlike formal opinions, informal opinions do not undergo a scrutiny process and are not considered the opinion of the Office. Informal opinions may be considered to be legal advice." *Id.* Consequently, an informal opinion would not be considered by the Court to be as persuasive as a formal opinion. *See*, 7A C.J.S. Attorney General § 34, Corpus Juris Secundum (September 2016 Update). However, as noted *ante*, the Attorney General's Office in this case argued federal interpretation should be used to construe at least the last phrase of section 59-7-113.

F. Adoption of Federal Rules

Though the Informal Attorney General Opinion does not carry great weight merely by virtue of its title or its having been issued in response to a Commission request for legal advice, its reasoning is persuasive. It is sound on the point of applying federal regulations and interpretations to section 59-7-113 to allow the Commission to apportion deductions under certain conditions. See *Buzas Baseball v. Salt Lake Trappers*, 925 P.2d 941, 947 fn.5 (Utah 1996), *citing, Brickyard Homeowners' Ass'n Management Comm. v. Gibbons Realty*, 668 P.2d 535, 540 (Utah 1983) ("Identity in language [in Utah and federal statutes] presumes identity of construction, so that we look to federal ... law for guidance.")

Although the Opinion was offered when issued to sweep in taxes and is now being launched by See's to minimize taxes, when taken with the other sections of Chapter 7 of title 59 of the Utah Code cited above and the pattern in *Continental Telephone, supra*, 539 P.2d at 447, of looking outside 59-7-113 for amplification and clairfication, the Court concludes it is appropriate to define the Commission's discretion by reference to the virtually identical federal statute, 26 U.S.C. section 482, and its accompanying tome of regulations on the same subject of apportionment and the need for arm's length analysis. In doing so, the Court notes there is no question about the relationship between See's and Columbia being "fuzzy and unclear." They are undisputedly affiliated corporations as defined in 59-7-113 and surrounding statutes. Also, Construing the deduction language of the section strictly would not seem to take us away from interpreting it in context of the statutory scheme which in turn adopts federal income tax definitions and principles. As noted above, the Commission may very well admit this point in its reliance on federal law to define "evasion of taxes," terms used in the statute.

G. Applying IRC 482 Arm's Length Principles

The parties agree if federal regulations guide resolution of this matter (the Commission does not concede or stipulate it does–it is addressing the issue assuming *arguendo* the regulations apply) then the deduction is authorized only if the amounts paid by See's to Columbia arise out of an "arm's length" transaction. The parties appear to agree key elements of such a transaction include the deal having a proper business purpose and being supported by an exchange of equivalent consideration–See's intellectual property for an equivalent amount of Columbia stock and annual payments by See's in exchange for equivalent value of using the trademarks and other IP Colombia now owns. Professor Swain argued the deal was a sham, but The Commission does not seem to go that far formally.

There are undercurrents to the question of an arm's length transfer. These include the impact of the Utah insurance taxation method–Utah taxes Columbia's premiums collected rather than its proportionate Utah income. If Utah taxed Columbia's income we would not have a conflict because the millions See's pays to it would be taxed to Columbia as proportionate adjusted income.

Also the experts who are all qualified and renowned in their fields have different opinions depending on who called them as witnesses–not a surprising development. The Commission's expert Prof. Swain believes the transaction not to be arm's length and a sham as just stated. The Commission does question See's motives, but is not claiming any illegality in the nefarious sense. Of course, as the Court noted, red-blooded Americans normally attempt to avoid or minimize tax liability at every opportunity, and political claims in vogue right now notwithstandin,, the practice is not tax evasion. There is no tax fraud alleged here.

Warren Buffet whose Berkshire Hathaway insurance conglomerate is the parent of See's and Columbia, had his company described by the Commission's expert as setting up the See's - Columbia deal solely to take advantage of the insurance premium-tax law to shift See's income to an essentially *de minimis* tax-paying insurance company. The expert opined there was thus no legitimate business purpose other than to get rid of tax liability. The parties did not test this premise by seeing whether Berkshire companies doing business only in insurance company income-taxing states used the same process to transfer IP. However, See's experts were able to point to Columbia being taxed on the royalties in states without premium tax.

The Commission's experts did acknowledge if the parties to the transaction were unrelated, it would pass muster for a tax deduction. There would be little or no need for arm's length analysis. However, as stated by counsel, the Commission's position is it does not matter whether there was an arm's length transaction. Because the two entities are related companies the Commission has discretion to redistribute the deduction under section 59-7-113 to ensure maximum taxation by nullifying anything that reduces income. "Our . . . argument is the simple fact that it reduces their tax by 82 percent. So . . . whether or not this is similar to what someone else would do . . . between unrelated parties, whether or not it's arm's-length . . . is not an element that is . . . required by the statute. . . . Our reliance is pretty much on the language of the statute that says . . . if it's between related parties . . . what happens between unrelated parties is really not relevant to that." However, as See's expert testified, the purpose of arm's length pricing is to put transfers between affiliated entities on equal footing with those between unaffiliated companies. This, arm's length is relevant under the framework of 59-7-113, counseled by IRC section 482 rules. The Utah statute even refers to affiliated and unaffiliated corporations.

See's also responded to this Commission position by noting Ms. Newsom of the Commission's Audit Division testified at the administrative proceeding one of the reasons the deduction should not be allowed was such a transaction would not take place between unrelated entites. Thus, See's would not have sold its IP in exchange for stock which carries no dividend payments and licensed it back on a non-exclusive basis had the corporations been unrelated. The Commission in its theory of the case disavows its auditor's analysis.

See's presented a pre-deal transfer evaluation by an independent accounting firm. On that basis it had an expert conclude there was a business purpose because See's was able to offload a function outside of its core mission and receive nearly a half billion dollars of stock in a respected Berkshire entity. It noted similar transactions elsewhere had been approved and the transaction of trading IP out for servicing in exchange for cash and other property was a normal occurrence between unrelated companies and in states without premium taxes.

The issue of the Oregon *Pacificare* case, *supra*, came up as a justification for the Commission's decision. The parties' experts had differing views of the effects of the case. Prof. Pomp for See's thought the case was distinguishable because it fell within the line of "sham" or prearranged transaction cases where the underlying agreement is made for the main purpose of avoiding tax liability. Thus there was no arm's length agreement. Also, Oregon had what is called an "add back statute" allowing its taxing authority to ignore some of the deduction. The Commissions's experts believed the case similar to this case and believed the state auditors were justified in citing to it.

The case did involve an IP transfer and royalty payments the taxpayer was trying to deduct. Further, the Oregon revenuers used a statute virtually identical to section 59-7-113 to reallocate income. However, the similarity generally ends there. The income was reallocated only after the auditors and Oregon revenue department determined the true owner of the IP remained the taxpayer. The tax Court made the same determination in upholding the reallocation. (*Pacificare*, *supra*, 19 Or.Tax at 478.) In our case, no one disputes Columbia and not the taxpayer See's owns the IP.

As noted *ante*, See's arm's length pricing appraisal was supported by expert testimony upon which the Court relies. The Commission's expert Prof. Swain, while able to argue the application of arm's length principles under law, was not qualified to dispute the underlying basis of the arm's length pricing itself, or even the business purpose of the transfer in this case.

H. Comparison of Positions

Each side's arguments appear to have some basis in law and fact. The Commission appears to acknowledge it does not have unlimited discretion to deny the deduction. Instead it argues the Commission's discretion is controlled by an abuse of discretion standard, citing in its proposed ruling to Utah Code Annotated section 59-7-610. The Court believes this cited section number to be a typographical error and is sure the Commission actually meant section 59-1-610, the statute pertaining to appellate review of Commission adjudicative proceedings. The Court of Appeals, however, has stated it "grants the Commission no deference concerning its conclusions of law, and applies a correction of error standard, unless there is an explicit grant of discretion contained in the statute before the court." *Beall v. Utah State Tax Com'n*, 2008 WL 5097700 (Utah App. (unpublished)).

This Court is not one of our appellate courts. But even under the principles the Commission relies on, the statute in the case at hand does not appear have an explicit grant of discretion in that it does not seem to have an unambiguous grant or an indication of what would be a proper exercise of discretion in allowing a readjustment to clearly reflect income. Thus, section 59-7-113 as discussed above appears to call for measuring income by going outside the statute and viewing related provisions to see how income is defined. If one were to do that in a transaction between the unrelated parties described in section 113, one would have to look to the deduction of business expense, including IP royalty expenses which deduction is in turn defined with reference to federal IRS regulations under IRC sections 162 and 482. With a transaction between affiliates, there is actually a specific IRS regulatory scheme to define what accurately reflects income and thus guides exercise of discretion.

Further, an abuse of discretion standard generally requires there be some law to apply to see if allowable discretion has been exceeded and to avoid arbitrariness and capriciousness. [2] The Commission indicates there is no question about a controlled exercise of discretion because the payment of royalties to Columbia for intellectual property sold by See's did not reflect profits earned by See's in Utah. See's is a higher end retailer and commanded a higher price in part because of brand loyalty associated with its IP. Its business activity in Utah is the same as before the transfer to Columbia. Therefore the Commission's argument is the 50 to 60 thousand dollars per year Utah deduction created a situation that failed to "clearly reflect income." However, See's is still using the intellectual property and one would expect its level of business at least to remain constant. Also it is arguably a more valuable company because it now has stock in Columbia worth over a half-billion dollars. Thus, it is not giving away value to another company as did the subsidiaries in *Continental, supra*, 539 P.2d 447. Its income is accurately reflected as indicated by the company's increasing value. While taxing that income may be deferred, the tax law allows it.

See's argues the only way to evaluate a proper exercise of Commission discretion is to look to the similar federal law. It supports this argument by asserting at least the Commission staff recognized its limitations See's does so by pointing to various perceived flaws and inaccurate

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[2] One measure of arbitrariness and capriciousness in administrative exercise of discretion is whether "statutes are drawn in such broad terms that in a given case there is no law to apply." *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 410 (1971), *abrogated on other grounds*, *Califano v. Sanders*, 430 U.S. 99, 105 (1977).

fact recitation in the Commission's decision. However, this is a trial *de novo* and *de novo* under the judicial review statute means just that. (See Utah Code Ann. §59-7-601.) The Commission is not strictly bound to its administrative record but the Court can use administrative statements by staff not necessarily to estop the Commission but to weigh how sincere the changes in position are–more or less to evaluate arbitrariness.

I. Summary

Utah Courts are familiar with what constitutes an arm's length transaction as the concept is dealt with frequently in Uniform Fraudulent Transfer Act cases brought pursuant to Utah Code Annotated section 25-6-1 et seq. The fundamental inquiry in such cases is whether an exchange involves giving and receiving fundamentally equivalent value without strings attached. Lack of such mutual value exchange indicates an attempt to avoid creditors. Federal arm's length regulations similarly focus on fair exchanges of value for tax deduction purposes. This focus overlays most aspects of the relevant federal tax regulations.

The parties agree *legitimate* IP royalty payments are a business expense that can be deducted from income under Utah and under federal tax laws. Thus, See's contends if it sold Columbia intellectual property in an arm's length transaction, as defined by the federal tax regulations, and now pays royalties under a licensing agreement for use of that property, it should be allowed to deduct the payments. If the transaction was other than arm's length, the payments would distort See's income by shifting part it to a related company. Evaluating the transaction first involved seeing whether there was a valid business purpose for it. If there was no valid purpose, the deal was essentially a sham with the result of improperly shifting tax liability to an entity that does not pay corporate franchise tax. This last point is the Commission's initial argument if federal law provides guidance, which again, it disputes and contends a transaction between affiliated corporations is by definition not arm's length.

Based on the many legitimate purposes See's (and Columbia) presented for the transaction, the expert testimony and similarity to agreements involving both affiliated and unaffiliated corporations, there is a case to be made of a business purpose. Further, applying section 482 principles which help interpret section 59-7-113 and the testimony of Mr. Kennedy and Dr. Cody, there is strong evidence of a business purpose in the See's-Columbia transfer.

The Court believes See's had an uphill task, however, establishing an arms length transaction. After all, it seemed conveniently owned by the same company that also owned a non-income taxed insurance company. It and several other subsidiaries transferred valuable intellectual property rights to that insurance company, got to use the same rights and at the same time reduce tax liability substantially by paying their owner's other company for the privilege.

The Commission's expert law professor opined the net unitary change in value of the parent company was zero but the output of the same value was taxed at a lower amount allowing See's worth to grow tax free. Taxable income was therefore distorted. Some states in fact have gone so far as to enact "add-back statutes" to ensure income is adjusted in transactions such as the one before the Court. Still, Utah has not done so and the Commission notes these add-back states have not adopted combined reporting.   The Commission's expert is not persuasive on his theory because he is basing much of it on a unitary system, which no party is admitting applies here. The Commission already determined See's and Columbia are not unitary and no substantial evidence at trial established they are.

The Commission argues section 59-7-113 is broad enough to deal with the facts presented because Utah has adopted combined reporting. The nature of the See's-Columbia transaction is a major point of the Commission in asserting the deduction should be disallowed, although if the entities are dissimilar in their business operations the combined reporting feature may be less relevant.   It does not appear there was any effort to impose combined reporting on See's and Columbia..

CONCLUSIONS OF LAW

Notwithstanding the strengths of the Commission's case, the Court concludes based on the foregoing analysis the Commission's discretion is intended to be limited by language outside section 59-7-113. The steps to this conclusion are: 1) The *Continental Telephone* case indicates the section relies on law outside its four corners to guide the Commission's exercise of discretion since the statute itself does not provide a formula for determining distortion or avoidance, and the principle of mere "equity" as a guide is at most vague. 2) There is nothing elsewhere in the related statutory scheme to indicate that guidance comes from other than the similar federal statute's regulations because Utah has developed no specific regulations to fill in the blanks of the statute. 3) Further, Utah income or franchise taxing relies heavily on federal definitions and section 59-7-113 is itself a virtual copy of IRC section 482, indicating, as provided in the Attorney General Opinion and Utah case law on similar statutes cited above, the Legislature wants to use federal guidance to interpret and apply the statute when dealing with whether a transaction is arm's length or not. 4) According to Prof. Pomp, the practice of arm's length pricing is not unusual in other states' taxing schemes.

Thus, the Commission should have exercised its discretion under regulations accompanying IRC section 482 to the factual situation in this csae. Commission auditors referred to these standards in their initial audits–business purpose and arm's length, but did not analyze them other than in a conclusory manner to announce the facts of the audit did not justify a deduction. Based on these considerations, it was an abuse of discretion for the Commission to deny the deduction *in toto* based on a classification of the transaction as per se outside of arm's length rather than analyze it under federal standards the Legislature impliedly incorporated in the statutory scheme surrounding section 59-7-113.

When the Court applies the regulatory principles to the evidence, applies the independent transfer pricing study from a Big 8 accounting firm, Deloitte-Touche, and takes into account the unrebutted testimony of the nature of the transfer and business purpose for it, as well as the review of its arm's length price, the Court concludes the transfer was arm's length justifying a deduction not barred under IRC section 482 and therefore not barred under Utah Code Annotated section 59-7-113.

However, deduction laws are to be construed narrowly against the taxpayer as expressed previously. This principle justifies the Court in reducing the deduction to the lowest level of the range of royalty rate. This exercise results in a 10% reduction of the royalty listed in See's returns. The 20% reduction proposed as an alternative in the MTC audit would be outside the calculated royalty pricing range.

See's petition is granted. It is entitled to a deduction of IP royalty payments to Columbia adjusted downward by 10 percent. Thus, it gets 90% of the payments as deductions. See's must also pay statutory interest through the date of this opinion on the disallowed 10 percent. The Court declines to compute these amount as it anticipates the parties will have no difficulty doing so. No further order is necessary to implement this ruling.

Dated this 6th day of October 2016

Samuel D. McVey
District Court Judge