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Utah District Court Clarifies Scope of Discretionary Authority Provision as Applied to Transfer Pricing Issues

On October 6, 2016, the Fourth Judicial District Court in Utah County upheld 90 percent of the deductions for royalty payments made by a taxpayer to a related party for the use of intellectual property.[1] In doing so, the District Court rejected an argument by the Utah Tax Commission (UTC) that Utah Code Ann. Sec. 59-7-113 gave it unfettered authority to reallocate income upon a finding of distortion of income for tax purposes. Instead, the District Court found that the UTC's discretion is limited by language outside the statute, specifically the regulations promulgated under Internal Revenue Code (IRC) Sec. 482.

Background

See's Corporate Structure

See's, a California corporation that sells candy in Utah through brick-and-mortar stores as well as through catalog sales, is a wholly-owned subsidiary of Berkshire-Hathaway, a publicly-owned conglomerate. BH Columbia is another wholly-owned subsidiary of Berkshire-Hathaway. Columbia Insurance Company (Columbia) is an admitted insurance company in Utah that sells insurance policies in Utah and is wholly owned by BH Columbia.

Intellectual Property Transaction

The litigation focused on an intellectual property transfer transaction from See's to Columbia that gave rise to the royalty payments made by See's. In 1997, Columbia offered to purchase intellectual property from See's for stock in BH Columbia. The value of the shares of BH Columbia transferred was equal to the value of the intellectual property as determined by a transfer pricing study. The provisions of the transaction were set forth in a non-exclusive license agreement that provided that Columbia would protect and develop the intellectual property and See's would pay quarterly royalties to license it back. Accordingly, See's paid royalties each quarter and then deducted these payments from income as business expenses. In order to make sure that the transaction met the arm's-length standard for transfers between related parties under IRC Sec. 482, an outside

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[1] *See's Candies, Inc. v. Utah State Tax Commission*, Fourth Judicial District Court, Utah County, No. 140401556, Oct. 6, 2016.

accounting firm was hired to set the value of Columbia BH stock and See's intellectual property. This valuation was also used in a second study to set the "arm's-length" rate of royalties for the use of the intellectual property.

The transaction enabled Columbia to issue more policies as the influx of royalties increased its surplus of reserves, and enabled See's to undertake additional corporate opportunities. Because of Columbia's expertise in intellectual property, it was ideally suited to develop and protect the trademarks and other intellectual property. Outsourcing the intellectual property to Columbia allowed See's to focus on its core business of making and selling candy.

In addition to these business purposes, the transaction allowed See's to obtain substantial Utah corporate franchise tax savings. As a result of the transaction, See's deducted from its reported income the significant payments that it made to Columbia for the use of the trademarks and other intellectual property. While the deduction amounts attributable to Utah range from $50,000 to $60,000 a year, See's deductions reduced its corporate franchise tax assessments by approximately 82 percent for each of the tax years that were the subject of this controversy. Further, the income generated by Columbia under the transaction was not reported by Columbia in Utah. As Utah subjected Columbia to the state's premiums tax as an admitted insurer, Utah taxed Columbia on its premiums instead of its income.

MTC and UTC Audits and Administrative Procedure

Utah is a member of the Multistate Tax Commission (MTC). As a means to provide guidance to its member states, the MTC performed a nonbinding audit of See's and approved See's Utah deduction for the 1995 to 1998 tax years subject to a 20 percent non-business royalty adjustment, which was later reduced to 10 percent. The MTC determined that the agreement between See's and Columbia had, under IRC Sec. 361, a valid business purpose.

In 2009, many years after the conclusion of the MTC audit, the UTC issued a Statutory Notice letter that disallowed See's royalty deductions for the 1999-2007 tax years. The UTC's auditors found that the shifting of income from See's to Columbia resulted in an understatement of income attributable to the business operations of See's. The auditors indicated that there was no business purpose for the transfer and no arm's-length transaction. The UTC relied on Utah Code Ann. Sec. 59-7-113 to reallocate income between two corporations to clearly reflect income.

In an administrative proceeding following the UTC audit, the UTC agreed with its auditors that Utah Code Ann. Sec. 59-7-113 prevented the shifting of income to Columbia through royalty payments since Columbia did not file corporate franchise tax returns in Utah, and the transaction ultimately resulted in an understatement of income attributable to See's business operations. In disallowing See's royalty deductions in full, the UTC did not address business purpose and arm's-length principles.

Utah Code Ann Sec. 59-7-113

Utah Code Ann. Sec. 59-7-113[2] is a provision which gives the UTC the ability to distribute deductions, if necessary, between corporations controlled by the same interest to clearly reflect income. Utah Code Ann. Sec. 59-7-113 is "almost identical" to IRC Sec. 482.[3] Unlike Utah Code Ann. Sec. 59-7-113, IRC Sec. 482 is accompanied by regulations that provide that, for determining deductions as business expenses resulting from transfers or payments from related parties, the framework "is rooted in whether the transaction was arm's length."

Utah District Court's Analysis

In considering whether and to what extent See's could deduct royalty expenses arising from the intercompany transaction with Columbia, the Court went through a detailed two-part analysis. First, the Court needed to address whether the Utah legislature incorporated federal provisions, specifically the regulations under IRC Sec. 482, when it enacted Utah Code Ann. Sec. 59-7-113. Next, if federal principles could be used as a guide, then those principles must be applied to determine whether the UTC could use its power to distribute income between entities and disallow See's royalty deductions.

UTC's Arguments

The UTC argued that Utah Code Ann. Sec. 59-7-113 serves as a stand-alone statutory provision that does not require reference to federal IRS regulations for its interpretation. According to the UTC, Utah Code Ann. Sec. 59-7-113 gives it "authority to reallocate income if it concludes in its broad discretion there is a distortion of income for tax purposes or avoidance of income." However, the UTC went on to state that, even if the federal regulations under IRC Sec. 482 guide the interpretation of Utah Code Ann. Sec. 59-7-113, See's failed to meet the federal "arm's-length" transaction standard solely because of the related-party nature of the transaction.

See's Arguments

See's argued that, because Utah Code Ann. Sec. 59-7-113 is "virtually identical" to IRC Sec. 482, the state statute necessarily looks to the federal regulations for its interpretation and application, and See's deduction was valid under the federal regulations. See's also

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[2] UTAH CODE ANN. SEC. 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."

[3] 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."

alleged that the UTC's administrative decision was arbitrary because it "was not made with reference to any appropriate standard."

Court Concludes Utah Had Intent to Incorporate Federal Provisions

For purposes of the first part of the analysis, the Court concluded that the Utah legislature intended to incorporate federal provisions and, as a result, the UTC's discretion under Utah Code Ann. Sec. 59-7-113 to redistribute income was limited by language outside the statute. The Court based its conclusion on four findings.

First, the Court looked to the Utah Supreme Court's decision in *Continental Telephone*[4] for the proposition that Utah Code Ann. Sec. 59-7-113 does not operate in isolation. *Continental Telephone* involved deductions for payments made by subsidiaries to a parent corporation to help pay for federal tax liabilities of both the subsidiaries and the parent corporation. The UTC relied on Utah Code Ann. Sec. 59-7-113[5] to disallow portions of the deductions to clearly reflect income. The District Court explained that *Continental Telephone* stands for the proposition that Utah Code Ann. Sec. 59-7-113 "relies on law outside its four corners to guide the Commission's exercise of discretion" because the statute itself does not provide a formula for determining distortion or avoidance and the principle of "equity" that it sets forth as a guide is "at most vague."

Next, the Court explained that guidance on Utah Code Ann. Sec. 59-7-113 must come from the analogous federal statute's regulations because there are no state-specific regulations promulgated under Utah Code Ann. Sec. 59-7-113.

Third, the Court explained that the Utah income / franchise tax relies heavily on federal income tax definitions and Utah Code Ann. Sec. 59-7-113 is a "virtual copy" of IRC Sec. 482, indicating, as evidenced in an informal attorney general opinion[6] and Utah case law on similar statutes, that the Utah legislature intended to use federal guidance to interpret and apply the statute when dealing with whether or not a transaction is arm's length.

Finally, the Court explained that, according to one of See's expert witnesses, other states have utilized arm's-length pricing in their tax regimes.

Based on this analysis, the Court concluded that the UTC should have exercised its discretion under the IRC Sec. 482 regulations to examine See's specific facts. The Court noted that the UTC's auditors referred to the business purpose and arm's-length standards in their initial audits but failed to "analyze them other than in a conclusory manner to announce the facts of the audit did not justify a deduction." The Court held that it was an abuse of discretion for the UTC to completely deny the deduction by finding the transaction did not qualify as arm's length rather than analyzing the issue under the federal standards that the Utah legislature incorporated by implication when adopting Utah Code Ann. Sec. 59-7-113.

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[4] *Continental Telephone Co. v. Utah State Tax Comm'n*, 539 P. 2d 447 (Utah 1975).
[5] At that time, the statute was numbered as UTAH CODE ANN. § 59-13-17.
[6] *Informal Opinion No. 79-214*, Office of the Attorney General, State of Utah, Dec. 5, 1979.

Court Applies Federal Provisions to Conclude Arm's-Length Transfer

Applying these federal standards, the Court summarily concluded that the transfer between See's and Columbia was an arm's-length transaction. In support of this conclusion, the Court pointed to the third-party transfer pricing analysis, the unrebutted testimony on the nature of the transfer and its business purpose, and the review of the arm's-length price. As a result, the deductions were not barred by IRC Sec. 482 or Utah Code Ann. Sec. 59-7-113. The Court did, however, under the principle that deductions are narrowly construed against the taxpayer, adopt the recommendations made by the MTC in its audit that the deductions be adjusted downward by 10 percent, which reduced the deduction to the lowest level of the royalty rate range.

Commentary

The Utah District Court's decision serves as a potentially valuable tool for taxpayers considering whether deductions arising from related-party arrangements will be respected. The importance of the Court's opinion is two-fold. First, the decision provides valuable information on the scope and limits of the UTC's power under Utah Code Ann. Sec. 59-7-113, an issue that previously had not been addressed by a Utah court. The Court held that the UTC did not have unfettered authority to reallocate income. Rather, its power was limited by the standards provided in the IRC Sec. 482 regulations.

Additionally, the decision provides valuable guidance on what support is necessary to determine when these related-party arrangements will be respected. While See's had to establish that its transaction with Columbia was made at arm's length in a situation in which a state income tax savings motive was present, See's deductions were respected because the company provided expert testimony that established significant business purposes for undertaking the transaction. Particularly noteworthy is the Court's decision to sustain the deductibility of 90 percent of the royalty payments with only a 10 percent downward adjustment. While the downward adjustment did lower the deduction to the lowest end of the royalty range, the royalty rate at the low end was a notable 17 percent. See's also had a transfer pricing study conducted to support the value of the intellectual property as well as the amount of the royalty payments, and the benefit of the MTC's analysis that substantially upheld the propriety of the deduction in years prior to the UTC audit.

Given the timely topic of transfer pricing with the advent of the MTC's State Intercompany Transactions Advisory Service Committee, one would expect that the close evaluation of transfer pricing controversies will continue. It will be interesting to see how the MTC and state tax authorities will interpret their discretionary authority powers in similar prospective fact patterns that come up at audit.
