2017

Utah State Tax Commission, Appellant, v. See's Candies, Inc., Appellee

Utah Supreme Court

IN THE UTAH SUPREME COURT

UTAH STATE TAX COMMISSION, Appellant, v. SEE'S CANDIES, INC., Appellee	Case No. 20160910-SC

BRIEF OF AMICUS CURIAE UTAH TAXPAYERS ASSOCIATION IN SUPPORT OF APPELLEE, SEE'S CANDIES, INC.

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SUMMARY OF ARGUMENT

Pursuant to Utah Rule of Appellate Procedure 25 and with leave of this Court, the Utah Taxpayers Association ("UTA"), by and through counsel of record, hereby files this *amicus curiae* brief in the above-captioned matter. The Utah State Tax Commission (the "Commission"), through this appeal, claims unprecedented and unfettered authority to increase a related corporate taxpayer's income tax liability by denying lawful deductions for expenses paid to related entities on the sole basis that the deductions reduce tax liability. This Court should reject that position and uphold the district court's decision, which applies the long-standing and reasonable principles of Utah Code section 59-7-113 ("Section 113") to put transactions between related taxpayers on tax parity to those with unrelated taxpayers.

The UTA is a statewide organization representing a broad array of taxpayers throughout Utah. It represents many taxpayers and investors potentially affected by this case and the Commission's claim of unfettered discretion. The purpose of the UTA is to promote efficient, economical government and fair and equitable taxation in Utah, including the furtherance and stimulation of the economy. The UTA submits this amicus brief to explain the far-reaching negative impact a reversal of the district court's ruling would have upon Utah taxpayers, potential investments in Utah, and on Utah's business climate in general.

BACKGROUND

Appellee See's Candies, Inc. ("See's") deducted royalty fees paid to a related company for the use of intellectual property in calculating its taxable income for corporate franchise tax purposes.[1] The district court held that See's was entitled to deduct the royalty fees under Utah law, and that See's income was clearly reflected under Section 113 after applying a small adjustment. District Court Decision at pp. 4-5. The federal government and many other states have statutes very similar to Section 113.[2] The district court applied Section 113 consistently with the application by the federal government, as well as with the application by all other states with statutes similar to Section 113, by upholding the majority of See's deductions because under an arm's length transaction analysis they were on par with royalty payments between by unrelated third parties entering similar transactions.

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[1] In 1997, Columbia Insurance Company ("Columbia") offered to purchase IP from See's (and other Berkshire subsidiaries) in exchange for stock. *See's Candies, Inc. v. Utah State Tax Commission*, Case No. 140401556, Utah Fourth Judicial District Court, October 6, 2016 Findings of Fact, Conclusions of Law and Final Decision ("District Court Decision") at ¶ 4. See's accepted the offer and, pursuant to a transfer pricing study, the value of the IP was assessed at about $450 million and was then exchanged for the equivalent value in preferred stock. *Id.* See's then licensed the intellectual property from Columbia in exchange for a royalty fee. *Id.* at ¶¶ 4-5. See's has deducted the royalty fees as an ordinary and necessary business expense on its Utah corporation franchise tax returns. *Id.* at ¶ 23.

[2] *See, e.g.*, 26 U.S.C. § 482; AZ Code § 43-942; CO Code § 39-22-303(6); DC Code § 47-1810.03; GA Code § 48-7-35; KS § 79-32,141; LA Code § 47:95(A); MS Code § 27-737(2)(c); MO Code § 148.040(4); MT Code § 15-31-141(5); ND Code § 57-3.4-03; NY CLS Code § 605; OH Code § 5733.031(B); OK Code § 2366; OR Code § 314.295; WV Code § 11-24-13a(f); WI Code § 71.30(2).

The Commission is now asking this Court to overturn this ruling of the district court, and to create a situation in Utah where—even though the taxpayer complies with all specific tax statutes expressly passed by the Legislature—the Commission would nevertheless have unbridled authority under Section 113 to recalculate a taxpayer's income any time a transaction between related taxpayers decreases income regardless of whether the transaction is on par with similar transactions of unrelated parties.

The UTA is aware of no case or situation at the federal level, or in any other state, where an executive branch of government is given authority to do what the Commission is requesting in this case – to reject in its entirety an expense paid to a related party simply because it has the effect of reducing income regardless of whether a similar transaction would have been entered by unrelated parties. As a result, if this Court were to adopt the Commission's position, Utah would become the only taxing authority (state or federal) to grant the executive branch unfettered discretion to deny lawful deductions simply because the deductions reduce taxable income.

ARGUMENT

I. THE COMMISSION'S INTERPRETATION OF SECTION 113 WOULD UNDERMINE UTAH'S STABLE AND PREDICTABLE RULE OF LAW AND THE RESULTING FAVORABLE BUSINESS CLIMATE.

The issue before this Court is whether the Commission has unfettered discretion under Section 113 to re-characterize valid business deductions between related entities anytime income decreases due to the deductions. The UTA agrees that the district court applied reasonable and longstanding standards for applying Section 113-type statutes, finding that the transaction between See's and Columbia had a valid business purpose,

and was consistent with transactions among unrelated parties. *See* District Court Decision at p. 34. The district court's approach rather than the Commission's approach will promote consistency and predictability for the taxpayers of Utah, thereby ensuring a more robust investment climate and economy for the State of Utah.

A. There are no instances of any government entity denying a deduction *in toto* using Section 113-type statutes as the Commission attempts to do here.

Importantly, the Commission's approach is not supported by any case precedent or other federal or state approaches. The UTA is not aware of the federal government or other state that has allowed the executive branch discretion to deny *in toto* valid deductions with business purpose on the sole basis that the deduction has reduced taxable income. Further and despite the fact that Section 113 and its predecessor law have been part of Utah's code since 1931, the Commission specifically admits "there are no state court decisions where a similar deduction was disallowed in its entirety under similar facts." District Court Decision ¶ 40. Further, the Commission previously permitted See's exact transaction under the related party standard. In its prior audit of See's in 1998, the Commission approved the exact same deduction on the exact same terms as the district court approved in the instant case. District Court Decision at ¶ 29. Now, the Commission is proposing that it be given authority never previously claimed or exercised, in contradiction to the position the Commission took in its prior audit of the very transactions in question.

B. The Commission claims unfettered discretion in applying Section 113.

In a complete change of opinion from its 1998 audit, the Commission now argues before this Court that the standards upheld by the district court should not be applied and that the arm's length pricing of a transaction should not even be reviewed. Tax Commission's May 1, 2017 Brief ("Commission Brief") at pp. 10-11. Rather the Commission claims it should have authority to deny a deduction any time income is reduced in a transaction between related entities. *Id.*at 30-31.

This about-face by the Commission is of grave concern to the UTA. The following statements by the Commission reflect its assertion that Section 113 gives it the right to deny a lawful deduction simply because the deduction "reduce[s] . . . taxable income":

> The See's/Columbia intercompany transactions have distorted See's income because, although See's business has not changed—it continues to sell candy in Utah under the See's tradename—the transactions reduced See's taxable Utah income by approximately 82% each of the subject tax years.

See Id. at p. 10 (emphasis added).

> . . . the Commission can distribute, apportion, or allocate income or deductions between related companies where doing so is necessary to . . . clearly show such a corporation's income. Here, [the See's transaction] purported to reduce See's taxable Utah income by approximately 82% each year. Thus, the Commission appropriately implemented Section 113 when it reallocated See's deductions for royalty payments to Columbia as income to See's.

Id. at pp. 30-31 (emphasis added).

The Commission's interpretation would allow it to "reallocate[] as income" any deductions that "reduce . . . taxable Utah income;" in other words—all deductions

between related parties are now at risk of being "reallocated as income" because, by definition and function, all deductions reduce income.

C. A standard is necessary to guide the application of the Commission's discretion under Section 113 and to safeguard Utah's taxpayers.

The only way to properly apply Section 113 is through employing a standard.[3] The district court correctly concluded that the proper standard for applying Section 113-type statutes is to put related taxpayers on par with unrelated taxpayers. District Court Decision at p. 34. This approach will promote consistency and predictability for taxpayers in our state. This standard has been uniformly applied for decades by the federal government and by states with Section 113-type statutes. *See, e.g., Commissioner v. First Sec. Bank*, 405 U.S. 394, 400, 92 S. Ct. 1085, 1089-1090 (1972) ("'[t]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer . . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer'") (*quoting* 26 CFR § 1.482-1(b)(1) (1971), and noting that "[t]he first regulations interpreting this section of the statute were issued in 1934 [and] [t]hey have remained virtually unchanged"); *Kellogg Co. v. Olson*, 675 S.W.2d 707, 709 (Tenn. 1984) (interpreting a Section 113-type state

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[3] In *Continental Telephone Co. of Utah v. State Tax Comm'n*, 539 P.2d 447 (Utah 1975), this Court "did not find unbridled equitable power in the Tax Commission to reallocate income between parties under section 59-7-113." District Court Decision at p. 24. The *Continental* Court looked outside of Section 113's predecessor statute to determine the meaning of federal "taxes paid" in order to decide whether reallocation of income under Section 113 was appropriate. *Id.* Even though partial reallocation was allowed in that case, it was not because the Commission had unfettered discretion, but because the Court concluded that a portion of the deductions claimed for "federal tax payments" were not actual payments of federal taxes. *See id.*

statute by looking to I.R.C. § 482 and stating "[t]he purpose of § 482 is 'to prevent the arbitrary shifting of income and deductions among controlled corporations and to place such corporations on a 'tax parity' with uncontrolled corporations") (quoting *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233, 1244 (Ct. Cl. 1969) ((citing Treas. Reg. § 1.482-1(1962))). This Court should ensure that this long-standing and reasonable standard remains the rule of law in Utah (and as applied by the Commission itself in its 1998 audit of the same transaction) by upholding the district court decision. Businesses thrive in a predictable legal environment and the district court's interpretation of current law is predictable and consistent. To maintain such an environment in Utah, the UTA encourages this Court to affirm the district court's application of a predictable standard for applying Section 113.

Unfortunately, the Commission flatly refuses to offer a standard by which it or other adjudicatory bodies can determine whether claiming a deduction is tax evasion or does not reflect the taxpayer's income as required by Section 113, *see* Commission Brief at p. 10. The Commission's argument that Section 113 itself provides a sufficient standard is unavailing and leaves Utah taxpayers economically vulnerable. The Commission claims that its interpretation of Section 113 limits its authority because reallocation can only take place in a "very narrow set of circumstances." Commission Brief, p. 12. According to the Commission, the "very narrow set of circumstances" are that parties to the transactions must be related and the Commission must conclude that reallocation "is necessary either (1) to prevent evasion of taxes or (2) to clearly reflect the income of any such corporation." *Id.* But the Commission then goes on to suggest that it

has authority to find "tax evasion" or a distortion of income any time a lawful deduction between related parties reduces taxable income, *id.* at p. 10, and pp. 30-31, which is functionally no limitation at all. According to the Commission, it is enough that the deduction reduces taxable income and works some form of "distort[ion]" to income. *See id.* at p. 10.

Thus, the test supplied by the Commission – essentially a regurgitation of Section 113 - is meaningless without a further standard. This is further evidenced by the fact that the federal government and other states with legislation similar to Section 113 have adopted the "arm's length transaction" test to ensure consistent implementation and fairness and overcome the patent vagueness of the statute.

Even if the Commission has the present intention to exercise restraint in deciding whether to reallocate deductions, the interpretation advocated by the Commission lacks a standard for future application and thus does not demand any restraint by future Commissions. This absence of a standard would cede too much taxation authority to unelected tax auditors, and would introduce significant uncertainty into Utah's business climate. Such an approach would discourage businesses from coming to Utah or expanding their current operations here.

D. The Commission's interpretations of "tax evasion" and "clearly reflect" from Section 113 are alarming for taxpayers, but should be viewed as limited by legislative enactments and restraints on the Commission.

The Commission declares that tax "'evasion' [is] akin to [tax] avoidance" and does not require "doing something illegal." Commission Brief, p. 16. Under the

Commission's expansive definition of "tax evasion," law-abiding related taxpayers could be labeled tax evaders by the Commission any time they legally deduct payments to related entities. The district court aptly characterized the Commission's position as asserting the "discretion to redistribute the deduction under section 59-7-113 to ensure maximum taxation by nullifying anything that reduces income." District Court Decision at p. 30 (emphasis added).[4]

The Commission also argues that the right to reallocate deductions to "clearly reflect" a taxpayer's income allows it to reallocate a legal deduction for the sole reason that the deduction reduces taxable income. The Commission reallocated See's deductions for its royalty payments to Columbia in order to "restore[] See's income to the same basis on which it was calculated before its intercompany property sale." Commission Brief, p. 18. The Commission did not and has not challenged the legal basis for the sale of intellectual property to Columbia or the deductions claimed by See's, yet it argues that the deduction distorts See's income solely because it reduces taxable income. *Id.* at pp. 16-18. The fact that reallocation of a deduction increases taxable income is not proof that the deductions were not lawful or that the taxpayer's income is not "clearly reflected." Any deduction, lawful or not, will always reduce taxable income. The denial

[4] In its order, the district court quoted the argument from the Commission's counsel as follows: "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." District Court Decision at p. 30 (ellipses in tax court's order).

of a deduction, lawful or not, will always result in an increase in taxable income. Thus, the outcome of an increase in taxable income due to a denial of a lawful deduction does not prove the legality of the Commission's actions any more than the Commission imposing a penalty proves guilt.

The UTA asserts that despite the Commission's contention for unfettered discretion in applying Section 113, the "Tax Commission, while created by constitutional mandate, is limited in its power and scope by the legislature." *Blaine Hudson Printing v. Utah State Tax Comm'n*, 870 P.2d 291, 293 (Utah Ct. App. 1994); *see also Mack v. Utah State Dep't of Commerce, Div. of Sec.*, 2009 UT 47, ¶ 33, 221 P.3d 194 ("District courts have general jurisdiction, which provides them with broad adjudicative authority. . . . Agencies, in contrast, are limited to the adjudicative authority granted by the legislature.") (internal citations omitted). The Commission's claim of such broad discretion under Section 113 ignores these important limits on its authority and would allow it the unprecedented right to "ensure maximum taxation by nullifying anything that reduces income." District Court Decision at p. 30. If the election of a taxpayer to take a deduction meets the reasonable standard found by the District Court, any further discretion by the Commissions is vitiated.

Again, the Commission did not and has not challenged the legal basis for the sale of intellectual property to Columbia or the deductions claimed by See's. It simply argues that using a deduction distorts See's income because it reduces taxable income. However and importantly, the Utah Legislature has expressly authorized numerous tax deductions, credits and exemptions in the Utah Code. Moreover, this Court has long upheld the right

of "the already overburdened taxpayer" to use "legally sanctioned ingenuity conceived in order to effectuate a tax saving." *Budget Homes v. State Tax Comm'n*, 120 Utah 425, 429 (Utah 1951).

Taxpayers routinely make substantial capital investments that result in income tax losses for a few years, with the expectation that these investments will produce profits in the future. Such business judgments of taxpayers are commonplace and should not be questioned by taxing authorities, even though income is decreased in a given tax year. So long as a deduction is legally permissible and, in the case of related entities, in an amount consistent with transactions among unrelated parties, the Commission's authority should not be extended to disallow valid deductions. Related taxpayers in Utah enter business transactions every day, and they should not be concerned that those transactions could be "undone" at the whim of a tax auditor, especially when the taxpayer has paid meticulous attention to ensure that the pricing is at fair value such as See's did with its Deloitte study. R. 502; F. ¶ 7.

II. THE COMMISSION CANNOT DISREGARD THE LEGISLATURE'S SPECIFIC TAXING SCHEME OR POLICY CONSIDERATIONS IN THE INTEREST OF GENERATING MORE TAX REVENUE. THAT IS THE SOLE PROVINCE OF THE LEGISLATURE.

The Commission should not be allowed to deny deductions for lawful payments to related entities simply because legislatively enacted statutes result in a tax outcome with which someone in the executive branch does not agree. By statute, the Utah Legislature has determined that insurance companies pay taxes based on premiums collected through a premiums tax rather than paying an income tax. *See* Utah Code Ann. § 59-7-102(1)

(1999) ("the following are exempt from this chapter: . . . (c) insurance companies which are otherwise taxed on their premiums under Title 59, Chapter 9, Taxation of Admitted Insurers"); *see also* 2017 Utah House Journal at p. 1827; 2017 Utah Senate Journal at p. 1468 (stating intent language for House Bill 42 (2017)). In passing House Bill 42, which clarified how insurance companies should be taxed, the House and Senate both voted to include the following intent language in the House and Senate Journal: "The philosophy in taxation of insurance companies has been that it is better for the state to exact the support for exercising a corporate business charter by taxing insurance premiums in lieu of taxing net income. In adopting such a philosophy, Utah, like most states, has made it clear that if an insurance company is subject to a premium tax then the net income of such company is not subject to the corporate income or franchise tax. This bill makes it clear that is, has been and will continue to be the philosophy of Utah." *Id.* These policy decisions were made by elected representatives in an open legislative process. The fact that, in a particular fact situation, a transaction with an insurance company results in the payment of less income tax than someone in the executive branch would like is not a basis under I.R.C. § 482, Utah's Section 113 or any other similar statute to disregard the transaction.

In *ExxonMobil Corp. v. Utah State Tax Comm'n*, 2003 UT 53 ¶ 22, 86 P.3d 706, 711, the Utah Supreme Court held that "any concerns we have with the reduction of revenue are not properly assuaged by an ends-based statutory interpretation." The Utah Legislature has chosen to tax insurance companies through premiums rather than income,

and the Commission is not authorized to deprive taxpayers of the income tax deductions permitted by these taxation statutes.

The current favorable business climate in Utah is the result of carefully thought out policies and rules of law established by the Legislature. Where, as here, the Commission claims the right to deny legitimate, legislatively authorized deductions simply because they reduce tax revenue, this Court should do as the district court correctly did and preserve separation of powers by preserving the right of the Legislature to establish the taxation rule of law for this state.

CONCLUSION

Adoption of the Commission's interpretation of Section 113 would be detrimental to Utah's business economy. This broad, aggressive posture of the executive branch would create an unfavorable, even threatening, tax climate in Utah. Such a posture would undermine the stable and predictable Utah business climate and economy putting Utah on an island as the only U.S. taxing authority to leave related taxpayers exposed to the whims of tax auditors, with no checks or balances. Where, as in this case as found by the district court, the tax deduction is ordinary and necessary, has business purpose, and, if between related parties, is equivalent to a transaction between unrelated parties—the executive branch has no authority to substitute its own business judgment for that of the taxpayer. *See* District Court Decision at p. 34. For the reasons set forth above, the UTA respectfully requests that this Court affirm the district court's decision.

RESPECTFULLY SUBMITTED this 21st day of August, 2017.

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CERTIFICATE OF COMPLIANCE

Pursuant to Utah Rule of Appellate Procedure 24(f)(1)(C), I hereby certify that this brief contains 4,123 words, according to the word count feature of the computer program used to prepare the brief.

Dated: August 21, 2017

By: _____
G. Wesley D. Quinton

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 21st day of August, 2017, a true and correct copy of the foregoing **BRIEF OF *AMICUS CURIAE* UTAH TAXPAYER'S ASSOCIATION IN SUPPORT OF APPELLEE, SEE'S CANDIES, INC.** was served in the manner and upon the recipients named below (the mailed copies will be sent upon the brief with original signature being filed with the Court):

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