

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
FROG DESIGN, INC. : DECISION
 : DTA NO. 824375
for Redetermination of a Deficiency or for Refund of :
Corporation Tax under Articles 9 and 27 of the Tax Law for :
the Years Ending December 31, 2000, December 31, 2001, :
December 31, 2002, December 31, 2003, August 31, 2004, :
March 31, 2005, March 31, 2006, August 31, 2006, :
March 31, 2007 and March 31, 2008. :

Petitioner, frog design, inc., and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on November 27, 2013. Petitioner appeared by Morrison & Foerster, LLP (Craig B. Fields, Esq., and Nicole L. Johnson, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Clifford Peterson, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner filed a brief in reply. Oral argument was heard in Albany, New York on October 15, 2014, which date began the six-month period for the issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. President Moseley Nero took no part in the consideration of this matter.

ISSUES

I. Whether the Division of Taxation properly assessed petitioner with the license fee pursuant to Tax Law former § 181.

II. Whether the license fee imposed upon petitioner fails the internal consistency test or whether it discriminates against petitioner such that it is unconstitutional as applied.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, except for findings of fact 3, 17 and 23, which we have modified to more accurately reflect the record. We have also added an additional finding of fact, numbered 25 herein. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional finding of fact are set forth below.

1. Petitioner, frog design, inc. (FDI), is a design company that provides the look, feel and customer experience for products. For example, petitioner designed a digital display window for answering machines. Petitioner was founded by Patricia Roller and her husband, Hartmut Esslinger.

2. On February 27, 1990, FDI was incorporated as a California corporation. Upon its formation in 1990, petitioner had 10,000 shares of authorized stock. From formation until 2004, Ms. Roller and Mr. Esslinger owned over 90% of the issued shares of petitioner.

3. In 1997, FDI opened an office in New York, New York. It began operating in 1998.

4. FDI's articles of incorporation originally authorized the issuance of 10,000 shares of common stock.

5. In 1991, FDI redeemed 2,500 shares of common stock.

6. In 1998, FDI amended its Articles of Incorporation to authorize a stock split, which converted every outstanding share of common stock into 1,000 shares of common stock.

7. On April 17, 2000, FDI again amended its Articles of Incorporation to authorize a second stock split, which converted every outstanding share of common stock into 10 shares of common stock.

8. FDI issued an additional 3,136,560 shares of common stock between June 2000 and March 2008.

9. During each of the periods at issue, FDI's total issued and outstanding shares were as follows: 80,536,180 for the period ended December 31, 2000; 80,546,320 for the periods ended December 31, 2001, December 31, 2002 and December 31, 2003; 80,546,560 for the periods ended August 31, 2004, March 31, 2005, March 31, 2006, August 31, 2006, March 31, 2007 and March 31, 2008.

10. In 2004, Flextronics, Inc. (Flextronics) purchased 85% of the issued shares of petitioner. The majority of the remaining 15% was owned by Ms. Roller and Mr. Esslinger.

11. Over a five-month period prior to the acquisition, Flextronics performed an exhaustive review of petitioner's tax filings. As a result, no issues were uncovered regarding petitioner's license fee obligations in New York.

12. In 2006, Kohlberg, Kravits & Roberts (KKR) purchased the 85% of shares of petitioner owned by Flextronics and the shares owned by Ms. Roller and Mr. Esslinger. Over a six-month period prior to the acquisition, KKR performed an exhaustive review of petitioner's tax filings. This review was performed by lawyers and accountants located in New York. As a result, no issues were uncovered regarding petitioner's license fee obligations in New York.

13. FDI's articles of incorporation do not state a par value for FDI's common stock.

14. In 1997, when FDI began doing business in New York, FDI reported its federal income tax and New York State franchise tax liabilities as a subchapter S corporation.

15. In 2000, FDI started reporting its federal income tax and New York State franchise tax liabilities as a subchapter C corporation.

16. FDI did not report or pay any license fee imposed by section 181 of the Tax Law for any of the periods ended December 31, 2000 through March 31, 2008.

17. In 2010, the Division of Taxation (Division) audited FDI's license fee liabilities for the periods in issue. During the course of the audit, the Division determined that petitioner did

not report or compute investment capital or subsidiary capital on its New York returns.

Petitioner therefore did not allocate investment capital or subsidiary capital to New York.

Petitioner allocated its income to New York by its reported or adjusted business allocation percentages (BAP).

18. The Division determined that FDI became liable for the license fee when it began filing as a subchapter C corporation in 2000.

19. The Division also determined that FDI's outstanding common stock had no par value.

20. During each of the periods at issue, FDI's BAP in New York was as follows: 5.9444% for the period ended December 31, 2000; 6.8519% for the period ended December 31, 2001; 7.8504% for the period ended December 31, 2002; 8.9675% for the period ended December 31, 2003; 15.9704% for the period ended August 31, 2004; 18.6481% for the period ended March 31, 2005; 23.2936% for the period ended March 31, 2006; 24.2131% for the period ended August 31, 2006; 29.7865% for the period ended March 31, 2007 and 25.5857% for the period ended March 31, 2008.

21. The Division determined that the amount of FDI's capital stock employed in New York State increased during the periods ended December 31, 2001 through March 31, 2007 as a result of the increase in FDI's BAP.

22. The Division also determined that FDI's capital share structure changed during the period ended March 31, 2006 as a result of FDI's issuance of additional shares.

23. Due to its determinations, the Division asserted a license fee due as follows for each of the periods at issue: \$230,078.00 for the period ended December 31, 2000; \$35,125.00 for the period ended December 31, 2001; \$38,647.00 for the period ended December 31, 2002; \$43,237.00 for the period ended December 31, 2003; \$271,047.00 for the period ended August 31, 2004; \$103,641.00 for the period ended March 31, 2005; \$216,332.00 for the period ended

March 31, 2006; \$37,031.00 for the period ended August 31, 2006; \$224,462.00 for the period ended March 31, 2007 and \$0.00 for the period ended March 31, 2008.

The Division computed such license fees at the rate applicable to no par value stock.

24. The Division issued notice of deficiency L-035410478, dated February 10, 2011, to FDI in the amount of \$1,199,600.00 plus interest and penalties, pursuant to section 1085 (a) (1) of the Tax Law, for the periods at issue.

25. Until 1996, petitioner's only office was located in California. Petitioner opened a second office in Austin, Texas in 1996. As noted previously, petitioner opened its New York office in 1997. Petitioner also opened offices in Ann Arbor, Michigan and Seattle, Washington in 1998 and 2006, respectively. Petitioner filed tax returns in all of these jurisdictions.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge determined that, pursuant to Tax Law former § 181 (b), the Division properly assessed a license fee against petitioner, a foreign corporation doing business in New York, on its issued shares of capital stock at the rate applicable to no par value stock.

The Administrative Law Judge rejected petitioner's assertion that its stock had a par value of \$1.00 per share pursuant to California Corporations Code (Cal. Corp. Code) § 205, and that, accordingly, the license fee should be computed at the lower par value rate.

The Administrative Law Judge also rejected petitioner's assertion that the license fee fails the internal consistency test as applied to petitioner and thus declined to find an as-applied commerce clause violation.

Additionally, the Administrative Law Judge rejected petitioner's claim that the license fee impermissibly discriminates against it because there was an exemption available to domestic corporations under the organization tax (Tax Law former § 180) that was not available to foreign corporations subject to the license fee (Tax Law former § 181 [b]). The referenced exemption

relates to shares resulting from a split (*see* Tax Law former § 180 [1] [b] [3]). The Administrative Law Judge determined that, since petitioner's first stock split occurred in 1998, before the first year it was assessed the license fee, petitioner was not subject to any discriminatory tax scheme.

Finally, the Administrative Law Judge abated penalty asserted in the notice of deficiency.

ARGUMENTS ON EXCEPTION

Petitioner continues to argue that its stock has a par value of \$1.00 per share and that, accordingly, the Division improperly computed its license fee liability. Specifically, petitioner asserts that Cal. Corp. Code § 205 deems a \$1.00 per share par value to its stock and that such deemed par value is effectively part of petitioner's articles of incorporation.

Petitioner also argues that the Full Faith and Credit Clause requires recognition of the California statute. Petitioner notes that the Division recognizes the statutes under which petitioner was organized and asserts that Cal. Corp. Code § 205 is part of the same chapter of organizational statutes.

Petitioner argues that, contrary to the determination, this matter does not involve the substitution of a California statute for a New York statute. Rather, petitioner asserts that the statutes at issue can be harmoniously applied and that the license fee can be determined by reliance on both the California deemed par value statute and the New York license fee statute.

Petitioner asserts that public policy considerations provide additional support for recognition of the California law pursuant to the Full Faith and Credit Clause. Specifically, petitioner contends that the public policy of New York is served by recognizing the California statute, as such recognition encourages business in New York.

Petitioner also contends that the principle of comity supports the recognition of the California statute, noting again the public policy benefits of recognizing the California statute.

As it did below, petitioner also continues to argue that the license fee fails the internal consistency test and thus violates the Commerce Clause as applied to petitioner. According to petitioner, if every state imposed an organization tax and license fee identical to that imposed by New York, the result would be that petitioner would be subject to tax on well over 100% of its shares.

Petitioner further asserts that the organization tax and license fee scheme is unconstitutionally discriminatory under the Commerce Clause as applied to petitioner because the organization tax provides an exemption to domestic corporations that is not available to foreign corporations paying the license fee. Specifically, the organization tax has an exemption for shares that are the result of a stock split, under certain conditions. Petitioner acknowledges that its stock split occurred in 1998, prior to any assessment of the license fee herein, but contends that it was subject to the license fee in 1998 and further contends that its “as applied challenge cannot be so rigid as to foreclose an argument simply because the Division fails to properly assess a tax.”

The Division contends that the Administrative Law Judge correctly declined to read Cal. Corp. Code § 205 into petitioner’s articles of incorporation.

The Division argues that Cal. Corp. Code § 205 is not an organizational statute, but is, rather, “California’s attempt to dictate New York tax policy.”

The Division notes that petitioner could have either stated a par value for its stock in its articles of incorporation or made reference to Cal. Corp. Code § 205 in its articles of incorporation, but did not. The Division notes that either such action would have been sufficient to allow petitioner to pay the license fee at the lower par value rate.

Contrary to petitioner’s contention, the Division takes the position that its computation of the license fee at the no par value rate does not offend the Full Faith and Credit Clause. The

Division asserts that petitioner is improperly attempting to substitute a California law for a New York law in this matter. The Division further asserts that New York may treat par and no par stock differently for tax purposes.

The Division rejects petitioner's assertion that the principle of comity supports the calculation of the license fee on a par value basis because, according to the Division, acceptance of petitioner's premise would create a scheme of unequal taxation, which would violate New York public policy.

The Division also denies that its imposition of the license fee fails the internal consistency test. The Division disagrees with petitioner's contention that Tax Law former §§ 180 and 181 should be considered together in the internal consistency analysis.

Finally, the Division contends that petitioner lacks an as applied discrimination argument under the Commerce Clause because the stock split giving rise to petitioner's discrimination argument occurred before January 1, 2000; that is, before the first taxable year for which the Division assessed the license fee against petitioner.

OPINION

During the years at issue, Tax Law former § 181 (1) (b) imposed a license fee on every foreign corporation for the privilege of exercising its corporate franchise or carrying on business in the state.¹ The license fee was imposed on the foreign corporation's shares employed within New York and its computation depended on whether the corporation's shares were issued with or without par value. Specifically, the rate for par value stock was "one-twentieth of one per centum" (i.e., .0005) of such par value per share, while the rate for no par value stock was "five cents per share" (.05). Given the modern corporate practice of assigning a nominal par value (*see*

¹ The license fee on foreign corporations under Tax Law former § 181 and the organization tax on domestic corporations under Tax Law former § 180 were repealed for taxable years commencing January 1, 2015 as part of the comprehensive corporate tax reform included in the 2014-2015 New York State Budget (*see* L 2014, ch 59).

Robert W. Hamilton, *The Law of Corporations*, § 7.6 at 176 [5th ed 2000]), this rate structure thus strongly discriminated in favor of corporations with par value stock.

Tax Law former § 181 (1) (c) provided for the recomputation of the license fee where the amount of capital stock employed in New York increased. Tax Law former § 181 (1) (d) set forth apportionment rules for purposes of calculating the license fee. The Division's audit determination that the amount of petitioner's capital stock employed in New York increased during the years at issue based upon increases in its BAP is not in dispute.

The California Corporations Code, under which petitioner was organized, accords "no legal significance to a share's par value" (Cox and Hazen, *Business Organizations Law*, § 16.8 at 504 [3d ed 2011]). Accordingly, in contrast to the New York Business Corporation Law, the California Corporations Code does not require that articles of incorporation either state a par value for shares or state that the shares are without par value (*compare* Business Corporation Law § 402 [a] [4] *with* Cal. Corp. Code § 202). A California corporation may include a statement of par value in its articles of incorporation (*see* Cal. Corp. Code § 204 [d]), but such a statement necessarily lacks "the traditional significance which corporate law attached to par value" (Franklin A. Gevurtz, *Corporation Law*, § 2.1 at 126 n 32 [2000]).

In recognition of the continued relevance of par value in other jurisdictions for the purpose of imposing taxes based on capitalization (such as Tax Law former § 181), Cal. Corp. Code § 205 provides, in part:

"Solely for the purpose of any statute or regulation imposing any tax or fee based upon the capitalization of a corporation, all authorized shares of a corporation organized under this division shall be deemed to have a nominal or par value of one dollar (\$1) per share."

Historically, the distinction between par value and no par value stock in Tax Law former

§ 181 (1) (b) was premised on substantive differences between those two classes of shares (*see New York v Latrobe*, 279 US 421 [1929] [equal protection not offended by different tax rates on par and no par stock under Tax Law former § 181 given the actual differences between the two classes of stock]; *Matter of Gulf Oil Corp. v State Tax Commn.*, 65 AD2d 157 [1978], *lv denied* 47 NY2d 708 [1979] [change from par value to no par value stock is a change in capital structure subject to an additional license fee under Tax Law former § 181 (1) (c) because of the “material differences” between the classes of shares]).

In the present matter, however, the Division’s denial of par value treatment of petitioner’s stock for license fee purposes is ultimately premised not on any meaningful differences between par value and no par value stock, but, as argued by the Division on exception, only on petitioner’s failure to include a statement of par value in its articles of incorporation. Given the elimination of par value from the California Corporations Code, such a statement would have no impact on the substantive characteristics of petitioner’s stock; nor would such a statement have any corporate law significance. Such a statement would thus be relevant only for tax purposes. Indeed, according to the Division, a statement consisting solely of an incorporation by reference of Cal. Corp. Code § 205 would suffice and, by its terms, that statute’s par value statement is relevant only for tax purposes.

Under these facts and circumstances, we find it reasonable to give effect to Cal. Corp. Code § 205 and to deem such provision to be part of petitioner’s articles of incorporation for purposes of Tax Law former § 181 (1) (b). We accept the Division’s interpretation of Tax Law former § 181 (1) (b) as set forth in its brief. That interpretation, as we understand it, is that a California corporation may be deemed to have par value stock for purposes of Tax Law former § 181 (1) (b) where its articles of incorporation include a statement of par value. Such a statement is provided by Cal. Corp. Code § 205.

Our decision to give effect to Cal. Corp. Code § 205 herein is consistent with decisions of New York courts that have given effect to statutes of other states related to a corporation's existence (*see Chaplin v Selznick*, 293 NY 529 [1944]; *Sinnott v Hanan*, 214 NY 454 [1915]). Our decision also finds support in *Detroit Mortg. Corp. v Vaughan, Sec'y of State*, 178 NW 697 [Mich. 1920], *affd* 182 NW 526 [Mich. 1921]. In that case, the Michigan court found a Delaware statute that deemed a par value for a Delaware corporation's stock for certain tax purposes to be effectively part of the Delaware corporation's charter.

As the Division correctly notes in its brief, a Texas court, in *Staples v Kirby Petroleum Co.*, 250 SW 293 [Tex. App. 1923], reviewed the same Delaware statute and concluded that the Delaware statute should not have any effect in Texas. The basis for the court's conclusion was language in the Delaware statute itself that limited the application of the statute to taxes payable by corporations to the state of Delaware and for no other purpose.² Here, Cal. Corp. Code § 205 contains no such limiting language. The rationale of *Staples v Kirby Petroleum Co.* is thus distinguishable from the instant matter.

We disagree with the Division's argument that Cal. Corp. Code § 205 is California's attempt to dictate New York tax policy. To the contrary, pursuant to the foregoing discussion, this provision appears to be consistent with the Division's interpretation of Tax Law former § 181 (1) (b), with which we concur, and as such, we find it to be consistent with New York tax policy.

With respect to petitioner's constitutional claims, we note that our authority is limited to as-applied challenges; facial constitutionality is presumed at the administrative level (*Matter of Eisenstein*, Tax Appeals Tribunal, March 27, 2003).

² The *Detroit Mortgage* decision ascribes no significance to this language.

Petitioner's contention that the license fee fails the internal consistency test relies on petitioner's assertion that the fee must be analyzed along with the organization tax on domestic corporations under Tax Law former § 180 to determine whether the license fee meets the test. We are unpersuaded by petitioner's argument. The license fee taxed foreign corporations. The organization tax was imposed on domestic corporations. These are mutually exclusive categories. Accordingly, we decline to analyze Tax Law former §§ 180 and 181 together for purposes of the internal consistency test. We agree with the Administrative Law Judge that, as properly analyzed separately from Tax Law former § 180, the license fee clearly met the internal consistency test (*see Goldberg v Sweet*, 488 US 252 [1989]).

We also reject petitioner's claim that the license fee is unconstitutionally discriminatory against it because the organization tax under Tax Law former § 180 provided for an exemption that was not available to foreign corporations subject to the license fee. We agree with the Administrative Law Judge's conclusion and the Division's argument herein that petitioner does not have an as-applied challenge because the stock split potentially giving rise to petitioner's discrimination claim occurred before the first taxable year for which the Division assessed the license fee against petitioner.

Finally, we note that the Division's exception herein did not contest any of the conclusions of law in the determination, but only requested an amended finding of fact. We have accepted the relevant part of the Division's proposed change following our review of the record.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of frog design, inc., is granted to the extent provided below, but is otherwise denied:

(a) The Division of Taxation is directed to modify the notice of deficiency, dated February 10, 2011, by recomputing the license fee under Tax Law former § 181 (1) (b) assessed against petitioner at the rate applicable for capital stock with a par value of \$1.00;

2. The exception of the Division of Taxation is granted to the extent indicated in finding of fact 17 herein;

3. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph 1 above, but is otherwise affirmed;

4. The petition of frog design, inc., is granted to the extent indicated in paragraph 1 above, but is otherwise denied; and

5. The notice of deficiency, dated February 10, 2011, as modified to the extent indicated in paragraph 1 above, is sustained.

DATED: Albany, New York
April 15, 2015

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner