STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MISTER DONUT OF AMERICA, INC.	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Year Ending February 29, 1984.	:	

Petitioner, Mister Donut of America, Inc., Multifoods Tower, Box 2942, Minneapolis, Minnesota 55402, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal year ending February 29, 1984 (File No. 805312).

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York on October 17, 1989 at 1:15 P.M., with all briefs to be filed by February 20, 1990. Petitioner appeared by Mr. Richard D. Kvamme. The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

ISSUE

Whether the gain realized by petitioner on the sale of franchise rights in Japan should be included in its New York entire net income for purposes of determining its New York franchise tax liability.

FINDINGS OF FACT

Petitioner, Mister Donut of America, Inc. ("MDA"), is a Delaware corporation. It has been in the business of franchising donut shops since 1955. In 1970, MDA became a wholly-owned subsidiary of International Multifoods Corporation ("IMC"). In April 1970, prior to IMC's acquisitionof MDA, MDA completed negotiations with Duskin Co., Ltd. ("Duskin"). Under this agreement Duskin, a Japanese company, became the franchisee of all Mister Donut

shops in Japan. The Duskin master franchise agreement was largely a result of the general interest of the stockholder of Duskin in the franchising business and he opened negotiations with MDA in order to develop donut shops in Japan. The intent of MDA was to spread the business to another geographic territory.

On December 21, 1983, MDA sold to Duskin, for $7,774,000.00, all of the goodwill of MDA in Japan and all right, title and interest of MDA in the trademarks registered in the name of MDA in Japan. Duskin also acquired an exclusive and perpetual right and license to manufacture and sell in Japan and to license others to manufacture in Japan, the bakery mix products and formulas of MDA. The sale represented the first sale of this kind in the approximately 30-year history of MDA.

MDA's other non-U.S. franchise activity consisted of operations in seven other countries - Philippines, Thailand, South Korea, Puerto Rico, Kuwait, France and Iceland. In most instances there was only one franchisee per country. In total, there were 39 donut shops in these countries.

The number of franchised donut shops in recent years in New York has fluctuated from 27 to 33. MDA has one company representative that spends about 90% of his time visiting and auditing donut shops in New York. The representative monitors compliance with the franchise agreement in the areas of quality, cleanliness and sanitation. He also answers franchisee questions regarding technical and administrative matters. In addition, MDA has a regional supervisor with an office outside of New York who spends approximately four weeks per year in New York. MDA headquarters personnel assist the franchisee with the purchase of equipment and the MDA headquarters marketing personnel assist in the selection of an appropriate retail location and assist in start-up of the shop.

MDA's marketing scheme in the U.S. consists primarily of providing the franchisees with advertising and promotional materials, such as newspaper ad slicks, TV and radio tapes, and on-site merchandising and promotional materials. A portion of the franchise fees is used by MDA to pay for media placement advertisements. In contrast, the overseas franchisees hired

their own advertising agencies and created their own promotional strategies.

Petitioner filed a New York State Corporation Franchise Tax Report for the fiscal year ending February 29, 1984 and paid the tax shown due thereon of $7,315.00. In computing the income base to which the business allocation percentage was applied, MDA excluded the gain from the sale to Duskin of all the Japanese franchise rights. For all prior years, MDA had included the franchise fees from Duskin in the income base to which the business allocation percentage was applied and included those same franchise fees in the denominator of the receipts factor used to compute the business allocation percentage.

On October 27, 1986, the Division issued a Notice of Deficiency to petitioner which asserted a deficiency of corporation franchise tax for the fiscal year ended February 29, 1984 in the amount of $34,684.00 plus interest of $10,650.00 for a total amount due of $45,334.00. The notice was issued on the basis of the Division's position that the gain on the sale of the foreign franchise was includible in entire net income.

MDA utilized one service representative for approximately every 30 franchise donut shops in the U.S. The service representatives monitor the store to ascertain whether they are conforming with the franchise agreement as to cleanliness, neatness and appearance. There was one service representative for all the 375 donut shops in Japan.

MDA offers training to all U.S. franchisees at both the outset of the agreement and also on an ongoing basis for business changes. In contrast, Duskin received initial MDA training only for approximately five Duskin representatives. Further training was handled entirely by Duskin. At its own expense, Duskin built its own training center. Thereafter, parties that purchased franchises from Duskin would go to Duskin, rather than MDA, for training.

The U.S. franchise agreements generally allow the franchisee to operate one donut shop in a specified geographic region. In contrast, the Duskin agreement was an exclusive master license for all of Japan. At that time that was the only franchise agreement of its kind. Duskin could decide where the donut shops would be located.

The U.S. franchise agreements called for an initial franchise fee of $25,000 and

continuing franchise fees of 4.9% of receipts. In contrast, the Duskin franchise agreement called for four initial franchise fees of $25,000.00 and the continuing franchise fees averaged approximately 2.4% of gross receipts.

The U.S. franchisees purchased their entire stock of supplies from an approved list of suppliers. In contrast, Duskin often purchased supplies from unapproved sources.

The U.S. franchisees purchased all of the donut-making equipment from an approved list of suppliers. However, Duskin arranged for production of its own equipment from within Japan. This was contrary to the franchise agreement.

In order to produce its own equipment, Duskin had engineers dismantle the equipment supplied by MDA. Thereafter, the engineers reassembled the equipment in the manner desired by Duskin.

The U.S. franchisees are required to utilize only approved formulas and recipes for donuts, icing etc. This is vital in maintaining uniformity of product. In contrast, Duskin altered, without MDA's consent, formulas and recipes so as to produce products which were inconsistent, cheaper and inferior when compared with those produced in the U.S.

The U.S. franchisees are restricted in what food items can be sold in donut shops. In contrast, Duskin sold, without MDA approval, numerous food items such as soups, sandwiches, hard boiled eggs and pastries.

The U.S. franchisees are required to report on a formal timetable the amount of gross receipts so as to accurately compute a continuing franchise fee. In contrast, Duskin reported gross receipts data on an irregular basis and for great lengths of time did not report at all.

The sale to Duskin of all rights to Japan did not result in any reduction whatsoever in the number of employees in the U.S. and had no impact on how the U.S. business was conducted.

The following summary of MDA's New York ratios, income tax liabilities, federal gross incomes, and federal taxable incomes for its years ended in 1981 through 1984, manifests the changes caused by the Japan sale.

Taxable Year Ended	New York Appor. Factor	New York Income Tax Liability	Federal Gross Income	Federal Taxable Income
2/81	3.05543%	$10,374	$10,063,248	$3,668,292
2/82	3.68523%	10,618	10,513,067	3,177,588
2/83	3.166729%	7,745	10,197,469	2,640,669
2/84 (Excluding Japan sale)	4.46161%	7,315	9,400,127	1,636,632
2/84 (Including Japan sale)	4.46161%	41,999	17,174,127	9,410,632

As a result of a tax conference before the former Tax Appeals Bureau, MDA's business allocation percentage was adjusted to include the receipts from the sale of the franchise in the receipts factor and the value of the intangible asset in the property factor. The Division felt that by making this adjustment any distortion caused by inclusion of the gain on the sale of the franchise would be eliminated. As a result of the recalculation, the New York State apportionment factor was reduced from 4.46161% to 3.0144% and the amount of tax asserted to be due was reduced from $34,684.00 to $21,061.00.

SUMMARY OF THE PARTIES' POSITIONS

It is petitioner's position that the New York statutory apportionment formula results in an unfair tax burden because it seeks to tax extraterritorial income and because it does not fairly represent the extent of MDA's business activity in New York. Therefore, petitioner maintains that the Commissioner should have exercised his authority to exclude the gain on the sale of the franchise rights to Duskin. In support of its argument, petitioner's brief calls attention to the following factors which allegedly establish that the New York and domestic franchise businesses were separate and distinct from the Japanese franchise businesses:

"1) Franchise agreement

NY/Domestic - A limited franchise agreement exists, generally only one shop that is run like a small sole-proprietorship.

Japan - Exclusive master license for all of Japan. One and only franchise agreement of its type for all of MDA's history. Duskin created sub-franchised shops.

2) Payments

NY/Domestic - The U.S. franchise agreements called for an initial franchise fee of $25,000 and continuing franchise fees of 4.9% of receipts for each shop.

Japan - Only four initial fees and continuing fees that averaged approximately 2.4%.

3) Servicing

NY/Domestic - One service representative for approximately every 30 shops with a wide scope of duties such as monitoring sanitary conditions, production equipment and provide advice for literally any franchisee concern.

Japan - One service representative for 350-400 shops. Naturally not able to monitor with anywhere near the depth as in U.S.

4) Training/Site Selection

NY/Domestic - MDA provides both initial and ongoing complete training for everything from technical baking skills to business record keeping skills.

Japan - MDA provided only initial training to about five Duskin representatives and from that point on Duskin handled all further training. Duskin even constructed an instruction facility in Japan at their own expense.

5) Food ingredients

NY/Domestic - Franchisees purchase their entire stock of food ingredients from an approved list of suppliers.

Japan - Duskin violated agreement by using unapproved suppliers. This resulted in end products that were cheaper and inferior products inconsistent with those produced in the U.S.

6) Formula

NY/Domestic - Franchisees are required to utilize only approved formulas and recipes for donuts, icing etc. This is vital in maintaining uniformity of product.

Japan - Duskin, again without approval, altered formulas and recipes so as to produce cheaper and inferior products inconsistent with those produced in the U.S.

7) Equipment

NY/Domestic - Franchisees purchased all of the donut making equipment from an approved list of suppliers.

Japan - MDA borrowed [sic] donut making equipment to

Duskin. Duskin engaged a Japanese engineering firm to dismantle the equipment and devise a strategy to rebuild essentially the same equipment, but avoid any patent problems. From that point on Duskin purchased Japanese manufactured equipment which was contrary to the franchise agreement.

8) Goods sold

NY/Domestic - Franchisees are strictly restricted in what food items can be sold in donut shops.

Japan - Duskin sold, again without MDA approval, numerous food items such as soups, sandwiches, hard-boiled eggs etc.

9) Reporting

NY/Domestic - Franchisees are required to report gross receipts on a rigid timetable so as to accurately compute continuing fees.

Japan - Duskin would not follow timetable and sometimes even refused to report anything. Another tactic of Duskin's was to report what appeared to be obviously understated gross receipt figures, thereby generating understated continuing franchise fees.

Further evidence of the separate and distinct nature is the fact that the sale to Duskin did not result in the reduction of MDA employees and did not result in the change of how the U.S. operation was conducted."

In addition to the foregoing grounds, petitioner argued at the hearing that in the United States franchisees pay a fee to MDA for advertising, whereas in Japan all advertising was handled by Duskin and that business practices between the United States and Japan are different. Petitioner also argued that the amount of tax sought by the Division does not fairly represent the amount of business activity conducted by MDA in New York.

It is the Division's position that the Japanese franchise and New York franchises are part of an integrated business. In addition, the Division maintains that in prior years petitioner's franchise tax revenues derived from foreign countries, including Japan, were part of the business receipts factor and petitioner's expenses incurred in creating value in franchise rights were deducted to determine New York tax due. Therefore, the Division argues that since income and expenses from non-New York operations were included in computing entire net income, there is no inequity in including the capital gain in the business allocation percentage.

The Division also argues that applying the business allocation percentage is neither unfair nor inequitable.

In response, petitioner argues that each year's filing must stand alone. Moreover, expenses associated with the Japanese franchise were small, and therefore New York arguably received a windfall in prior years.

CONCLUSIONS OF LAW

A. New York imposes a franchise tax on every corporation doing business in New York State (Tax Law § 209.1; 20 NYCRR § 1-3.2). The franchise tax is computed on the highest one of four alternative bases (Tax Law § 210.1).

In this instance, it is undisputed that petitioner properly calculated its liability on the basis of 10% of its entire net income which was allocated to New York. The term "entire net income" is defined by Tax Law § 208.9 as "total net income from all sources, which shall be presumably the same as the entire taxable income which the taxpayer is required to report to the United States treasury department". The percentage of business income allocable to New York (the business allocation percentage) is based on a statutory formula utilizing property, business receipts and payroll (Tax Law § 210.3[a]).

When the business allocation percentage did not reasonably reflect a taxpayer's business activity in New York, the former State Tax Commission (now the Commissioner of Taxation) was authorized, in its discretion, to adjust the formula by excluding one or more of the three factors, excluding one or more assets or making other adjustments (Tax Law § 210.8; 20 NYCRR § 4-6.1). Here, as previously noted, MDA argues that application of the statutory apportionment formula results in an unfair tax burden because it seeks to tax extraterritorial income and because it is allegedly not representative of MDA's business activity in New York.

B. Before proceeding to the merits, it is briefly noted that since petitioner's argument pertains to the constitutionality of the Tax Law as applied, the issues are properly presented in this forum (see, e.g., Matter of J.C. Penney Co., Inc., Tax Appeals Tribunal, April 27, 1989).

C. In Mobil Oil Corp. v. Commissioner of Taxes (445 US 425), the Court set forth the

limits of a state's authority to tax income derived from interstate commerce under an apportionment scheme. The Court explained that, in general, in order for a state to tax income derived from interstate commerce "the Due Process Clause of the Fourteenth Amendment imposes two requirements: a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise [citations omitted]" (Mobil Oil Corp. v. Commissioner of Taxes, supra, at 436-437). The Court further explained that the requisite "nexus" is present if the corporation conducts business within the state (Mobil Oil Corp. v. Commissioner of Taxes, supra, at 437). Further, a sufficient "nexus" would be present if the income earned outside the state was from activities related to the business conducted within the taxing jurisdiction (see, Mobil Oil Corp. v. Commissioner of Taxes, supra, at 439). This concept, known as the unitary-business principle, has been characterized as "the linchpin of apportionability in the field of state income taxation" (Mobil Oil Corp. v. Commissioner of Taxes, supra, at 439). It examines whether the income was earned from activities which are unrelated to the business activities in the taxing jurisdiction or whether the income is from activities which are part of an integrated enterprise (Mobil Oil Corp. v. Commissioner of Taxes, supra; see also, Exxon Corp. v. Department of Revenue, 447 US 207; F. W. Woolworth Co. v. Taxation and Revenue Department, 458 US 354). In the latter instance, a state may tax income derived from interstate commerce under an apportionment scheme (Mobil Oil Corp. v. Commissioner of Taxes, supra).

D. The foregoing concepts have been recognized and applied in New York. For example, in People ex rel. Sheraton Buildings v. Tax Commission (15 AD2d 142, 222 NYS2d 192, affd 13 NY2d 802, 242 NYS2d 226) relator was a Massachusetts corporation which owned and operated a hotel in Buffalo, New York. It also owned and operated an office building in Boston, Massachusetts. During the year in issue, it sold the office building in Boston and realized a long-term capital gain. Relator did not include this gain on its New York franchise tax report which, in turn, led the State Tax Commission to assert a deficiency of corporation franchise tax. The Court first concluded that the operation of the hotel in Buffalo and the office

building in Boston were entirely unrelated and in no sense could they be regarded as a "unitary" business. As a result, the Court held that the capital gain on the sale of the office building in Boston did not have to to be included in the New York report. Similarly, in Matter of Bonner Properties, Inc. (State Tax Commn., April 6, 1984) the taxpayer was permitted to exclude the gain on the sale of a low-income apartment building in Virginia from its New York franchise tax report. In reaching its decision, the State Tax Commission noted, among other things, that the businesses were operated separately, that they maintained separate books and records, that the receipts were deposited, and the expenses were paid through separate accounts and that there were no transactions between the separate corporations. The Commission also noted that the gain on the sale of the Virginia property was almost 200 times the income earned by petitioner from its activities in New York, that petitioner paid a substantial tax on its gain from the sale to the State of Virginia, and that petitioner conducted its business in New York for less than 3 years prior to its sale of the Virginia property which it owned for over 20 years. On the basis of these facts, the State Tax Commission concluded that it would be inequitable to require petitioner to include the gain from the sale of the property in its New York entire net income.

E. Viewed by the foregoing standards, MDA has not established that its franchise agreement with Duskin in Japan was not a part of a unitary business which petitioner conducted in New York. The crux of the matter is not whether the separate franchisees had differences in the way they conducted their individual franchises, but whether the franchises as a group were part of a unitary franchise business conducted by MDA. Here, there is no evidence that MDA had separate managements for awarding its franchise in Japan as opposed to its franchise in New York or evidence of any other significant factor which shows that the granting of the franchise rights to Duskin was a separate and distinct business from the awarding of franchises in New York. The first four factors raised in petitioner's brief (see Finding of Fact "20") and the item involving advertising reflect the fact that the size of the franchise operation in Japan was larger than that conducted by the franchises in New York. However, these factors do not show that the separate franchises were not created as part of an integrated franchise business. Factors

5 through 9 in petitioner's brief (Finding of Fact "20") show that petitioner may have had some cause of action against Duskin arising from a breach of contract. However, as before, they do not show that the agreement with Duskin was not part of an integrated franchise business. The last factor set forth in MDA's brief similarly has no bearing on whether the franchise in Japan was part of an integrated business. In this regard, Matter of Bonner Properties, Inc. (supra), which was relied upon by petitioner, does not warrant a different result. Unlike the situation in Bonner, petitioner has not shown that the arrangement with Duskin as opposed to the one in New York was operated separately within petitioner's management structure or that petitioner maintained separate books and records or bank accounts with respect to the separate franchises. Petitioner has also not shown that it paid any tax to Japan on the sale of the franchise or that the holding period of the Japanese franchise was significantly different from the holding period of those franchises which operated in New York. In view of the foregoing, petitioner has not shown that Bonner lends support to its position.

F. It is recognized that the tax burden was significantly greater for the fiscal year in issue than in prior years. However, any unfairness was cured by the adjustments made at the former Tax Appeals Bureau conference which reduced the business allocation percentage to a level commensurate with the business allocation percentage of prior years. Therefore, petitioner has not shown that there is any unfairness from the adjusted asserted deficiency of franchise tax.

G. The petition of Mister Donut of America, Inc. is denied and the Notice of Deficiency, as adjusted at the conference, is sustained.

DATED: Troy, New York

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ADMINISTRATIVE LAW JUDGE