STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	DETERMINATION DTA NO. 824375
FROG DESIGN, INC.	:	
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., filed a petition 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.

A hearing was held before Donna M. Gardiner, Administrative Law Judge, at the offices of the Division of Tax Appeals, 1384 Broadway, New York, New York, on December 5, 2012 at 11:00 A.M., with all briefs to be submitted by May 31, 2013, which date began the six-month period for the issuance of this determination. 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).

ISSUES

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

III. Whether petitioner has demonstrated that it acted with reasonable cause and without wilful neglect such that the penalty should be abated.

FINDINGS OF FACT

The parties entered into a stipulation of facts, which has been incorporated into the findings below except for paragraph numbers 22, 23 and 24, which facts have no bearing on the issues of this case. Additionally, petitioner submitted proposed findings of fact numbered 1 through 36. Such proposed findings of fact have been generally accepted and incorporated herein except for proposed findings of fact 2, 3, 6, 7, 9, 11, 12 and 36, which are rejected as irrelevant, and proposed findings of fact 17, 18, 20, 21 and 22 have been modified to the extent that the phrase "due diligence" has been deleted as being conclusory in nature.

1. Petitioner 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, frog design, inc. (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.

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.

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 business allocation percentage (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.

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.

CONCLUSIONS OF LAW

A. Section 181 of the Tax Law imposes a license fee on every foreign corporation for the privilege of exercising its corporate franchise or carrying on business in the state (Tax Law § 181[1][b]). The computation of the fee is dependent on whether the corporation's shares are with or without par value. The Division computed the license fees as if petitioner's shares were without par value. Petitioner claims that its stock has a par value of $1.00 per share pursuant to its Articles of Incorporation.

Petitioner concedes that its Articles of Incorporation do not state a par value. Therefore, petitioner urges that, pursuant to California law, its shares have a deemed par value of $1.00. Petitioner states that in 1975, the California Legislature undertook a complete revision of its corporation law and, consequently, it eliminated the significance of par value under the California Corporation Code.

B. In New York State, the Business Corporation Law continues to distinguish between stock with par value and stock without par value (***see*** Business Corporation Law § 501[a]). As such, petitioner must operate under the laws of New York. Since petitioner's stock is without par

value, the corporation pays a fee of five cents on each issued share of stock employed within the State (Tax Law § 181[1][b]).

Furthermore, Tax Law § 181(1)(c) states, in pertinent part, that:

> In any case where . . . the amount of capital stock employed in the state is increased, the fee shall be recomputed on the basis of such change or increase, and there shall be credited against the fee, as recomputed, the amount of any fee that may have been previously paid pursuant to this section. . . .

Tax Law § 181(1) further provides, in pertinent part, that:

> [t]he measure of the amount of capital stock employed in this state shall be . . . that proportion of [the foreign corporation's] capital stock which is equal to the proportion of its business, investment and subsidiary capital allocable within the state pursuant to the provisions of [Article 9-A] (Tax Law § 181[1][d]).

Finally, section 4-2.1 of the Regulations instructs that:

> A taxpayer which has no investment capital and no subsidiary capital determines only a business allocation percentage. Thus, a taxpayer which has only business income and business capital must allocate its entire net income and its total capital by the business allocation percentage (20 NYCRR 4-2.1).

C. As set forth in the facts, petitioner did not pay the license fee, its outstanding shares of stock were issued without a par value, it only used its BAP to allocate its entire net income to New York and its BAP increased each year beginning with the tax period ending December 31, 2001 through the tax period ending March 31, 2007.

Tax Law § 181 clearly provides for taxation of a foreign corporation's stock issued without par value and that is employed within New York State. It is untenable for the Division to first apply laws outside of its jurisdiction before it relies on the plain language of New York law that is directly applicable to the facts herein. Therefore, the Division properly assessed petitioner the license fees for the periods at issue.

D. Petitioner further argues that the license fee as imposed by the Division fails the internal consistency test as applied to it. Petitioner reasons that it would be subject to multiple taxation, if every state in which it did business imposed New York's tax scheme.

The Tax Appeals Tribunal has applied the internal consistency test on a number of occasions to determine whether a certain imposition of tax was fairly apportioned, such that its imposition did not violate the Commerce Clause of the United States Constitution (***see Matter of General Elec. Co.***, Tax Appeals Tribunal, March 5, 1992 [wherein Tax Law § 1105(c)(5) was determined to fail the internal consistency test since New York State was imposing tax on an integrated waste removal service where certain components of the entire integrated service would have been taxed in several jurisdictions if such jurisdiction applied an identical statute to that in New York]).

As set forth in ***Goldberg v. Sweet*** (488 US 252 [1995]), to be internally consistent, a tax must be structured so that if every state were to impose an identical tax, no multiple taxation would result. As the Division correctly points out, petitioner herein was taxed for the privilege of exercising its corporate franchise or carrying on its business within New York based on the amount of capital stock it employed within New York, which employment was calculated by utilizing petitioner's BAP. No other jurisdiction can impose tax on these activities conducted solely within New York State. As such, the taxation scheme under Tax Law § 181 as applied to petitioner is internally consistent.

E. Petitioner also argues that the imposition of the license fee is discriminatory under the Commerce Clause. Petitioner states that there is an exemption available to domestic corporations that it cannot use since it is not a domestic corporation, but rather, a foreign corporation. Petitioner relies on ***Oregon Waste Sys. v. Department of Envtl. Quality*** (511 US 93 [1994]), for the proposition that a tax or fee is discriminatory if it treats domestic corporations

and foreign corporations differently, such that domestic corporations receive the benefit of an exemption solely due to its being a domestic corporation. This argument must be rejected.

Petitioner states that section 180 of the Tax Law provides domestic corporations with an exemption from the taxation of shares of stock that results from a prior stock split that foreign corporations under Tax Law § 181 are not allowed. As the Division correctly states, petitioner relies on events that occurred before January 1, 2000 to demonstrate discrimination against it. Petitioner's 1998 stock split occurred prior to its first taxable year for which it was assessed the license fee, i.e., the taxable period ending December 31, 2000. As such, petitioner was not in a position to avail itself of the law with respect to the exemption for domestic corporations pursuant to Tax Law § 180 and, as such, has failed to demonstrate a discriminatory tax scheme as applied to it.

F. As it has been determined that the imposition of the license fee was appropriate in this case, the final issue to be addressed is whether the penalty imposed pursuant to Tax Law § 1085(a)(1) can be abated based upon reasonable cause and not wilful neglect.

Tax Law § 1085(a)(1) imposes a penalty for the failure to file a return. As Ms. Roller testified, petitioner hired accounting firms to determine which taxes were owed in every state in which petitioner conducted business. Ms. Roller credibly testified that she relied on those firms for their expertise and the firms never informed her that a license fee was owed in New York. During the periods at issue, petitioner was acquired by Flextronics and, subsequently, by KKR. During both acquisitions, there was an exhaustive review of petitioner's tax filings and at no point was the obligation for license fees discovered. Accordingly, it is found that petitioner acted with reasonable cause and without wilful neglect. Therefore, the penalty is abated.

G. The petition of frog design, inc., is granted to the extent indicated in Conclusion of Law F, but is otherwise denied, and the Notice of Deficiency L-035410478, dated February 10, 2011, as modified, is sustained.

DATED: Albany, New York
November 27, 2013

/s/ Donna M. Gardiner
ADMINISTRATIVE LAW JUDGE