

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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In the Matter of the Petition	:	
of	:	
<b>WHOLE FOODS MARKET GROUP, INC.</b>	:	DECISION DTA NO. 826409
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Tax Years Ended September 28, 2008, September 27, 2009 and September 26, 2010.	:	

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Petitioner, Whole Foods Market Group, Inc., filed an exception to the determination of the Administrative Law Judge issued on July 14, 2016. Petitioner appeared by PricewaterhouseCoopers LLP (Michael Zargari, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief. Oral argument was heard in New York, New York, on March 9, 2017, 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.

***ISSUE***

Whether the Division of Taxation properly determined that petitioner was obligated to file a combined report with Whole Foods Market IP, LP for the tax years in issue.

***FINDING OF FACTS***

We find the facts as determined by the Administrative Law Judge except that we have

omitted findings of fact 12 through 19, which summarize the respective positions of the parties. As so modified, such facts are set forth below.

1. Whole Foods Market Group, Inc. (WFMG), a Delaware corporation, distributed and sold natural and organic food products at its retail stores in the United States, including at its stores in New York, all of which were located within the Metropolitan Commuter Transportation District (MCTD) during the tax years ended September 28, 2008, September 27, 2009 and September 26, 2010 (tax years in issue or audit period).

2. Whole Foods Market IP, LP (WFMIP), a Delaware limited partnership, owned various trademarks, trade names and other intangible assets. In 2002, WFMIP converted from a corporation (Whole Foods Market IP, Inc.) to its current form, a limited partnership. Upon conversion, WFMIP elected to be treated as a corporation for federal income tax purposes.

3. WFMG and WFMIP were each 100 percent owned and controlled, directly or indirectly, by Whole Foods Market, Inc. (WFM), a Texas corporation. WFMIP Investments, Inc. owned and controlled 99.99 percent of the interests in WFMIP. WFMIP Management, Inc. owned and controlled the remaining .01 percent interest in WFMIP. WFM owned and controlled 100 percent of the stock of WFMIP Investments Inc., as well as 100 percent of the stock of WFMIP Management, Inc.

4. WFMG and WFMIP were included in a federal consolidated group during the audit period. WFMIP did not have nexus with New York and did not file general business corporation franchise tax returns, forms CT-3, during the audit period.

5. WFMG paid royalties to WFMIP for the rights to use such trademarks and other intellectual property in its retail operations for the audit period pursuant to the terms and

conditions of a Trademark License Agreement entered into by the parties, effective September 25, 2000. WFMG paid said royalties in the following amounts during the audit period:

<b>Tax Year Ended</b>	<b>Royalties</b>
September 28, 2008	\$118,399,296.00
September 27, 2009	\$122,355,031.00
September 26, 2010	\$137,821,212.00

WFMG deducted the royalty payments on its federal income tax returns and the same amounts were included in WFMIP's federal taxable income during the audit period. For each of the tax years in the audit period, the royalties paid by petitioner to WFMIP were less than 50% of petitioner's total expenses.

6. During the audit period, the total receipts earned by WFMIP were as follows:

<b>Tax Year Ended</b>	<b>Total Receipts</b>
September 28, 2008	\$209,527,429.00
September 27, 2009	\$214,110,416.00
September 26, 2010	\$238,736,324.00

7. The royalties paid by WFMG to WFMIP were the only quantifiable intercorporate transactions between WFMG and WFMIP during the audit period. Even so, WFMG and WFMIP were engaged in a unitary business throughout the audit period. Expressed as a percentage of WFMIP's total receipts, the receipts received by WFMIP from WFMG for each of the tax years in issue were as follows:

<b>Tax Year Ended</b>	<b>Percentage of Receipts</b>
September 28, 2008	56.5078%

September 27, 2009	57.1458%
September 26, 2010	57.7295%

8. WFMG deducted the royalties it paid to WFMIP on its federal income tax returns during the audit period and added back the royalties in calculating its New York entire net income, as follows:

<b>Tax Year Ended</b>	<b>Royalties Added Back</b>
September 28, 2008	\$118,399,296.00
September 27, 2009	\$122,355,031.00
September 26, 2010	\$137,821,212.00

WFMG had added back its royalty payments to WFMIP since 2003.

9. The Division audited WFMG's corporation franchise tax returns for each of the years in the audit period. The Division determined that WFMG and WFMIP met all the requirements to file a combined report pursuant to Tax Law § 211 (4), including the substantial intercorporate transaction requirement, essentially disallowing the royalty add-back and requiring WFMG to file a combined report with WFMIP.

10. On May 2, 2013, the Division issued a notice of deficiency to petitioner, asserting additional tax, interest and penalty as follows:

<b>Year Ended</b>	<b>Tax</b>	<b>Interest</b>	<b>Penalty</b>
September 28, 2008	\$616,657.00	\$248,590.96	\$61,665.00
September 28, 2008	\$132,886.00 (MTA)	\$53,570.35	\$13,288.00
September 27, 2009	\$698,823.00	\$209,066.70	\$69,882.00

September 27, 2009	\$150,591.00 (MTA)	\$45,051.86	\$15,059.00
September 26, 2010	\$781,769.00	\$156,008.42	\$78,176.00
September 26, 2010	\$168,466.00 (MTA)	\$33,619.04	\$16,846.00
Total	\$2,549,192.00	\$745,907.33	\$254,916.00

The total amount of additional tax, interest and penalty due was stated as \$3,550,015.33.

11. The Division imposed penalties for substantial understatement of tax in the amount of ten percent of the underpayment attributable to such understatement pursuant to Tax Law § 1085 (k).

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

The Administrative Law Judge commenced the determination in this matter by noting that New York imposes a franchise tax on all corporations doing business, employing capital, owning or leasing property or maintaining an office in the state. He noted that such tax was imposed on the highest of four bases, one of which was entire net income.

The Administrative Law Judge then described the method for computing entire net income under the Tax Law, which involves adjusting federal taxable income for certain state-specific items, one of which is royalty payments. He contrasted the pre-2007 method of arriving at a taxpayer's entire net income with tax years starting in and after 2007. Entire net income was determined under the prior scheme by requiring a taxpayer to add back royalty payments made to a related corporate member to the taxpayer's federal taxable income. In turn, the related corporate member receiving the royalty payments was permitted a deduction equal to those payments from its federal taxable income in arriving at its own entire net income. The Administrative Law Judge noted that this add-back/deduction scheme was amended for tax years

beginning in 2007 and was thenceforth only applicable where the taxpayer did not report its income on a combined basis with a related member. The Administrative Law Judge highlighted the importance of this amendment when viewed together with the new requirement under Tax Law § 211 (4) of combined reporting for tax years beginning in 2007 for all related corporate members engaging in substantial intercorporate transactions and engaging in a unitary business.

The Administrative Law Judge continued his analysis by noting that the only issue in dispute, considering that the parties had stipulated that petitioner and WFMIP were related members of a group and that petitioner added back its royalty payments to WFMIP, was whether petitioner was obligated under the amended Tax Law to file a combined report with its related members, thus obviating the need to add back the royalty payments.

The Administrative Law Judge cited the statutes amended for tax years beginning in 2007 and noted that the Division was mandated by statute to consider and evaluate all activities and transactions of the taxpayer and related corporations.

The Administrative Law Judge next described the Division's technical services memorandum that provided taxpayer guidance on the subject of mandatory combined reporting. According to the guidance contained in that memorandum, later codified into the Division's regulations, substantial intercorporate transactions would be found where 50% or more of a corporation's receipts included in computation of entire net income are from a related member. Relying on the combined reporting statute as amended for tax years beginning in and after 2007, the Administrative Law Judge reasoned that petitioner's royalty payments for use of WFMIP's intellectual property constituted intercorporate activities and transactions that would obligate petitioner to report on a combined basis. In support of this conclusion, the Administrative Law

Judge noted that the technical services memorandum specifically listed trademarks and patents as assets that must be considered in determining whether substantial intercorporate transactions had taken place. In consideration of the stipulated facts that greater than 50% of WFMIP's receipts stemmed from transactions with petitioner for use of WFMIP's trademarks, the Administrative Law Judge concluded that petitioner was under an obligation to report income on a combined basis with WFMIP.

The Administrative Law Judge was unconvinced by petitioner's argument that there were no quantifiable intercorporate transactions because the definition of entire net income included the add-back and deduction of the royalty payments. The Administrative Law Judge reasoned that petitioner ignored the actual intercorporate transactions at issue in this matter, namely petitioner's royalty payments for use of WFMIP's intellectual property pursuant to their trademark licensing agreement, in order to reach this conclusion. The Administrative Law Judge found this to be an unreasonable interpretation of the statutory language. According to the Administrative Law Judge, petitioner should have first completed the analysis determining whether combined reporting was required based on the facts and circumstances of all activities and transactions rather than determining whether its entire net income should include an add-back of these intercorporate payments.

The Administrative Law Judge rejected petitioner's argument that the legislative intent to tax royalty payments made to foreign corporations would necessarily be frustrated by abandoning the royalty add-back/deduction scheme. The Administrative Law Judge reasoned that adding back the royalty payments is not the sole method of achieving this goal. The Administrative Law Judge explained that a corporate taxpayer's income would not be distorted by requiring

combined reporting with a related member, but rather, as a result of applying the New York business allocation percentage, such income calculation would reflect a fair representation of its in-state activities.

Similarly, the Administrative Law Judge found no merit in petitioner's argument that the penalties assessed for substantial understatement of tax should be abated. He did not agree with petitioner that its interpretation of the Tax Law in effect at the time was a reasonable one. Citing the statute providing for the penalty, the Administrative Law Judge noted that petitioner bore the burden of showing reasonable cause for the reporting position resulting in the deficiency. In order to show that it acted reasonably and in good faith, a taxpayer bears the burden of demonstrating the extent of its efforts in ascertaining its correct tax liability. According to the Administrative Law Judge, petitioner failed to meet this burden, citing its failure to seek clarification of the 2007 amendments to the Tax Law in justification for its tax reporting position.

The Administrative Law Judge concluded by denying the petition and sustaining the notice of deficiency.

#### ***ARGUMENTS ON EXCEPTION***

Petitioner argues that it properly added back to its federal taxable income the royalty payments it made to WFMIP under the law in effect during the audit period and in compliance with the guidance published by the Division on this issue. Petitioner argues that it was not required to file a combined report with WFMIP during the audit period because determining whether combined reporting was required needed to take into account its entire net income as that term is defined under the Tax Law. Petitioner posits that determining its entire net income



required it to add back the royalty payments it made to WFMIP to its federal taxable income and reasons that the legislative intent to impose taxation on royalty payments to a related corporate member would be foiled by a combination requirement. Petitioner contends that the net result of its royalty payment add-back and WFMIP's deduction of such payments was that there were no substantial intercorporate transactions between it and WFMIP for purposes of determining whether combined reporting would be required, arguing that the add-back/deduction mandate under Tax Law § 208 (9) (o) eliminated the intercompany transactions related to royalty payments for purposes of calculating entire net income. Since calculating entire net income is an indispensable step in determining whether a taxpayer is obligated to submit a combined report, petitioner argues, it could not have been required to file a combined report with WFMIP where those transactions are not counted as part of intercorporate receipts.

Petitioner argues that, in the absence of substantial intercorporate transactions, there must be a showing of activities that would result in distortion of its taxable income in order for combined reporting to be required. Petitioner believes that requiring it to file a combined report would be an abuse of the discretion afforded the Division under the Tax Law. Lastly, petitioner asks that the penalty imposed for substantial understatement of tax be abated due to petitioner's reasonable interpretation of the Tax Law in effect during the audit period, which it made in good faith.

The Division argues that the Tax Law in effect during the audit period obligated a corporate taxpayer to first determine if combined reporting was required; if not, add-backs of royalty payments would be required in determining entire net income. In support of its position, the Division points to the amendment of Tax Law § 208, which made royalty payment add-backs

inapplicable to taxpayers that reported on a combined basis. According to the Division, this amendment of the Tax Law necessitates resolving the issue of whether combined reporting would be required before the issue of royalty add-backs could be addressed.

According to the Division, as there is no dispute that petitioner and WFMIP were related and engaged in a unitary business, the only issue in dispute here is whether there were substantial intercorporate transactions between petitioner and its related members that obligated it to submit a combined report. The Division contends that the royalty payments constitute substantial intercorporate transactions since WFMIP received more than 50 percent of its receipts from WFMG during the audit period.

The Division urges this Tribunal to affirm the imposition of penalty for substantial understatement of tax during the audit period. The Division states that petitioner should have been aware of the amendment to Tax Law § 208 and the factors requiring combined reporting during the audit period. The Division rejects petitioner's contention that it made reasonable efforts to ascertain its proper tax liability in light of the available taxpayer guidance, which ultimately undermines petitioner's claim that it acted in good faith.

### ***OPINION***

We begin with New York's corporate franchise tax in effect during the audit period. As stated by the Administrative Law Judge, New York's corporate franchise tax is imposed upon the highest of four bases of corporations doing business, employing capital, owning or leasing property or maintaining an office in New York (Tax Law former §§ 210 [1]; 209 [1]). One of those bases is entire net income (Tax Law former § 210 [1] [a]). Entire net income means total net income from all sources and is presumed to be the same as federal taxable income adjusted

for certain New York-specific items (Tax Law § 208 [9]; *see also* 20 NYCRR 3-2.2). During the audit period, except where related members reported on a combined basis, intercorporate royalty payments to a related member, to the extent deductible for federal purposes, were required to be added back to federal taxable income in calculating entire net income (Tax Law § 208 [9] [o] [2]). To the extent that those royalty payments were added back to the federal taxable income of a taxpayer, the related member was allowed a deduction from its federal taxable income in arriving at its entire net income (Tax Law § 208 [9] [o] [3]).

Just prior to the audit period, amendments to Tax Law § 211 made combined reporting mandatory for related corporations in a unitary business and engaging in substantial intercorporate transactions (Tax Law § 211 [4]; *see also* L 2007, ch 60, Pt J). In addition to making combined reporting obligatory for corporations meeting the statutory criteria, the statute required the Division to consider and evaluate “all activities and transactions” of a taxpayer and its related corporations in making the determination whether such taxpayer was under a duty to make a combined report (Tax Law § 211 [4] [a]). According to the bill jacket accompanying this amendment to Tax Law § 211, the legislative intent behind the amendment was to ensure that related corporations engaging in transactions that transferred, among other things, trademarks were subject to obligatory combined reporting (*see* New York Bill Jacket, L 2007, Sen. Bill 2110, ch 60).

Taxpayer guidance issued in a technical services bulletin (TSB-M) by the Division described what constituted substantial intercorporate transactions for purposes of the combined reporting requirement (TSB-M-08[2]C, *Combined Reporting for General Business Corporations*, March 3, 2008; *superceding* TSB-M-07[6]C, June 25, 2007). The TSB-M stated that a

determination of substantial intercorporate transactions for purposes of the combined reporting requirement would be based on an examination of “*the facts and circumstances of all activities and transactions*” between related corporations, including the transfer of trademarks from one or more related corporations (*id.*, emphasis added). Under the TSB-M, intercorporate receipts, intercorporate expenditures and intercorporate transfers of assets all constitute intercorporate transactions (*id.*). Under the test for finding substantial intercorporate transactions by measurement of intercorporate receipts, receipts received from related members in excess of 50% of a related member’s total receipts “*included in the calculation of entire net income*” will be deemed to be substantial intercorporate transactions (*id.*, emphasis added). This guidance on what constituted substantial intercorporate transactions and the intercorporate receipts test was eventually codified into the Division’s regulations on combined reporting (*see* 20 NYCRR 6-2.3).

The dispute in this matter arises from the seeming conflict between the statutory definition of entire net income under Tax Law § 208, the combined reporting requirement under Tax Law § 211 and the guidance issued by the Division in the TSB-M pursuant to the amended combined reporting statute. In other words, the question at issue is whether any substantial intercorporate transactions for purposes of the mandatory combined reporting statute can be found, when the definition of substantial intercorporate transactions, by reference to entire net income, seems to require backing out the intercorporate transactions that actually occurred.

We answer this question in the affirmative. We agree with the Division that the transactions between petitioner and WFMIP pursuant to their agreement to license certain trademarks constituted substantial intercorporate transfers for purposes of Tax Law § 211, thus

obligating the taxpayer to report its income on a combined basis with WFMP.

The effect of Tax Law § 208 (9) (o) is to include royalty payments made to a related member in a corporation's entire net income where such payments would not otherwise be included in that corporation's entire net income. For example, royalty payments would be properly added back to a corporate taxpayer's federal taxable income in arriving at entire net income if combined reporting were not required for some other reason, such as lack of substantial ownership of a would-be related member, lack of engagement in a unitary business or the related member was an alien corporation (*see* 20 NYCRR 6-2.3). In contrast, the effect of Tax Law § 211 (4) is to include a related member in a combined report where there are substantial intercorporate transactions of many types, including royalty payments, with that related member. Interpreting Tax Law §§ 208 and 211 in the manner that petitioner suggests is inconsistent with both the language and intent of the overall statutory scheme, especially in light of the amendment of Tax Law § 211 (4) that requires the commissioner to "consider and evaluate all activities and transactions of the taxpayer and its related corporations," including transactions for rights to trademarks (*see* Tax Law § 211 [4] [a]; TSB-M-08[2]C). It would also render the amendment to Tax Law § 208 (9) (o) adding the language exempting companies that file on a combined basis meaningless where intellectual property is held by a related corporate member and payments for use of that intellectual property make up greater than 50% of such member's gross receipts. The intent of the statutory amendments to Tax Law §§ 208 and 211 is even more evident when compared to our prior decisions regarding royalty payments to related corporations under discretionary combined reporting (*see e.g. Matter of the Talbots*, Tax Appeals Tribunal, September 8, 2008; *Matter of the Sherwin-Williams Co.*, Tax Appeals Tribunal, June 5, 2003,

*confirmed Matter of Sherwin-Williams Co. v Tax Appeals Trib. of the Dept. of Taxation & Fin. of State of N.Y.*, 12 AD3d 112 [3d Dept 2004], *lv denied* 4 NY3d 709 [2005]).

Turning to petitioner's argument that the penalty for substantial understatement of tax should be abated, we agree with petitioner that there was good cause for its reporting position and that it acted in good faith. Therefore, the penalty for substantial understatement of tax pursuant to Tax Law § 1085 (k) is abated. Key to our finding here is the language found in the TSB-M itself:

“The substantial intercorporate transactions requirement will be satisfied when, during the taxable year, 50% or more of a corporation's receipts included in the computation of entire net income (excluding nonrecurring items) are from one or more related corporations” (TSB-M [08]2C).

Under Tax Law former § 208 (9), “entire net income” includes by definition petitioner's royalty payments made to WFMIP as an add-back to federal taxable income if it was not included in a combined report with a related member pursuant to Tax Law § 211 (Tax Law § 208 [9] [o] [2]). In turn, to the extent included in petitioner's entire net income, WFMIP's receipts from royalty payments from petitioner are deducted in arriving at its entire net income (Tax Law former § 208 [9] [o] [3]). The taxpayer guidance contained in the TSB-M describes the types of transactions that would be evaluated in determining whether substantial intercorporate transactions for purposes of requiring combined reporting were present, including the transfers of trademarks and other intellectual property that are at issue here (*see* TSB-M-08[2]C). The TSB-M then describes substantial as a situation where more than 50% of the total receipts of a corporation that are used in calculation of the corporation's entire net income are from related members (*id.*). Thus, the TSB-M implies that the intercorporate transactions at issue should be at the same time included and excluded from the calculation of substantial intercorporate transactions. We cannot say that

petitioner acted unreasonably in taking the reporting position it did considering the Division's circular references in the TSB-M in defining the parameters for determining whether combined reporting was required as a percentage of intercorporate receipts. Petitioner reasonably, but erroneously, interpreted the Division's guidance as requiring it to back out the intercorporate royalty transactions in arriving at WFMIP's entire net income for purposes of determining whether 50% of WFMIP's receipts were from a related member. In light of the circumstances, we find that there was good cause for petitioner's understatement of its tax liability for the tax years in question and that it reported its New York taxable income in good faith.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Whole Foods Market Group, Inc. is denied, except with respect to the imposition of the penalty for substantial understatement of tax as described herein;
2. The determination of the Administrative Law Judge is affirmed, except with respect to conclusion of law E thereof;
3. The petition of Whole Foods Market Group, Inc. is denied, except with respect to the imposition of the penalty for substantial understatement of tax; and
4. The Division of Taxation is directed to modify the notice of deficiency dated May 2, 2013 in accordance with this opinion by canceling the penalty for substantial understatement of tax, but such notice is otherwise sustained.

DATED: Albany, New York  
September 11, 2017

/s/ Roberta Moseley Nero  
Roberta Moseley Nero  
President

/s/ Dierdre K. Scozzafava  
Dierdre K. Scozzafava  
Commissioner

/s/ Anthony Giardina  
Anthony Giardina  
Commissioner