STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| **WHOLE FOODS MARKET GROUP , INC.** | : | DETERMINATION<br>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. | :<br>:<br>: | |

Petitioner, Whole Foods Market Group, Inc., 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 tax years ended September 28, 2008, September 27, 2009 and September 26, 2010.

On October 30, 2015 and November 9, 2015, respectively, petitioner, appearing by PricewaterhouseCoopers LLP (Michael Zargari, Esq., of counsel), and the Division of Taxation, appearing by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel), waived a hearing and submitted the matter for determination based on documents and briefs to be submitted by March 7, 2016, which date began the six-month period for issuance of this determination. After due consideration of the documents and arguments submitted, Joseph W. Pinto, Jr., Administrative Law Judge, renders the following determination.

## *ISSUE*

Whether the Division of Taxation properly determined that petitioner should have filed on a combined basis with Whole Foods Market IP, LP for the tax years in issue.

## *FINDINGS OF FACT*

The parties entered into a stipulation of facts pursuant to 20 NYCRR 3000.11, which has been incorporated into the Findings of Fact below, except paragraphs 39 through 43 which pertain to procedural matters and paragraph 32, which recites a statutory amendment.

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:

| TAX YEAR ENDED | ROYALTIES |
|---|---|
| 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:

| TAX YEAR ENDED | TOTAL RECEIPTS |
|---|---|
| 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:

| TAX YEAR ENDED | PERCENTAGE OF RECEIPTS |
|---|---|
| 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:

| TAX YEAR ENDED | ROYALTIES ADDED BACK |
|---|---|
| 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:

| YEAR ENDED | TAX | INTEREST | PENALTY |
|---|---|---|---|
| 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).

***SUMMARY OF THE PARTIES' POSITIONS***

12. The parties have agreed that the following are not at issue herein: the requirement set forth in Tax Law former § 208(9)(o)(2)(A) that petitioner and WFMIP be related members; the requirement set forth in Tax Law § 211(4)(a) that petitioner and WFMIP be related corporations; the constitutional requirement that petitioner and WFMIP be engaged in a unitary business to file a combined report pursuant to Tax Law § 211(4); the requirement set forth in Tax Law former § 208(9)(o)(2)(A) that petitioner made royalty payments to WFMIP; and the exceptions to the royalty add-back set forth in Tax Law former § 208(9)(o)(2)(B).

13. Petitioner argues that under the law in effect during the audit period, petitioner properly added back to its entire net income the royalty payments it paid to WFMIP, and that it was not required to first file a combined report with WFMIP, noting that the legislative intent behind

royalty add-backs would be foiled by such a combination requirement. Additionally, petitioner contends that there were no substantial intercorporate transactions between it and WFMIP because there were no qualifying activities between them, since the add-back eliminated the intercompany transactions.

14. Petitioner maintains that requiring it to file a combined report with WFMIP would distort its proper tax liability in New York. Petitioner notes that in the absence of substantial intercorporate transactions, there must be a showing of activities that would give rise to distortion, such as where one corporation provides management, corporate, administrative and logistical services to a related corporation at cost or without reimbursement. Petitioner believes that without such activities, which it does not believe are present herein, distortion would not arise out of its separate filing in New York.

15. Petitioner contends that allowing the Division to use the discretion bestowed upon it by Tax Law § 211(5) to require combination would be abusive, since there has been no showing of an agreement, understanding, or arrangement that would serve to improperly reflect petitioner's activities, income or capital in New York.

16. Finally, petitioner believes that the penalty imposed for substantial understatement of tax should be abated due to petitioner's bona fide and reasonable interpretation of the Tax Law in effect when the returns were prepared. Underscoring its position, petitioner notes that this is a case of first impression, supplying it with no precedent on which to rely.

17. The Division argues that the add-back statute requires taxpayers to first determine if combined reporting is warranted. The Division points to the amendment of the Tax Law former § 208(9)(o)(2)(A), which added critical language addressed to circumstances where a taxpayer was included in a combined report with a related member. Based on this change in the law, the

Division urges that before the issue of royalty add-backs can be addressed, the issue of combination must be resolved.

18. The Division believes combination was warranted under the facts presented. Since there is no dispute that petitioner and WFMIP were related and engaged in a unitary business, the only issue with respect to whether they should be required to file on a combined basis is whether there are substantial intercorporate transactions between them. The Division contends that the royalty payments satisfy that requirement since WFMIP received more than 50 percent of its receipts from WFMG during the audit period.

19. The Division further argues that the substantial understatement of tax penalty should not be abated since no reasonable cause therefor has been demonstrated. The Division believes that petitioner should have been aware of the statutory amendment to Tax Law former § 208(9)(o)(2)(A) and the combined reporting mandate. The Division maintains that such an oversight belies petitioner's contention that it made adequate efforts to ascertain its proper tax liability and vitiates its contention that it acted in good faith.

## ***CONCLUSIONS OF LAW***

A. During the audit period, Article 9-A of the Tax Law provided for a corporate franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property or maintaining an office in New York (Tax Law former § 209[1]). The corporate franchise tax was imposed on the highest of four bases, one of which was entire net income (Tax Law former § 210[1]). In computing entire net income, a taxpayer started with its federal taxable income and then added back or subtracted certain state-specific items (Tax Law § 208[9]; 20 NYCRR 3-2.2[b]). One modification concerned royalty payments.

Prior to 2007, Tax Law former § 208(9)(o)(2)(A) required taxpayers to add back royalty payments made to a related member that were deductible in calculating federal taxable income. In 2007, Tax Law former § 208(9)(o)(2)(A) was amended[1] to provide for an exception where the taxpayer was included in a combined report:

> "Except where a taxpayer is included in a combined report with a related member pursuant to subdivision four of section two hundred eleven of this article, for the purpose of computing entire net income or other applicable taxable basis, a taxpayer must add back royalty payments to a related member during the taxable year to the extent deductible in calculating federal taxable income."

It is not disputed that WFMG and WFMIP were related members of a group, brother and sister corporations owned by WFM, engaged in a unitary business. It is not disputed that WFMG paid royalty payments to WFMIP and that WFMG deducted its royalty payments to WFMIP in calculating its federal taxable income. What is in dispute, and the focus of this determination, is whether WFMG added these payments back to its New York income properly while filing separately, or if it should have filed on a combined basis with WFMIP, as the Division urges, thus obviating the need to add back the royalty payments.

B. The provision in Tax Law former § 208(9)(o)(2)(A) was coordinated with the change in Tax Law § 211(4)(a). Effective for taxable years commencing on or after January 1, 2007, Tax Law § 211(4)(a) was amended (***see*** L 2007, ch 60) to require combined reporting where the substantial ownership requirement is met and where "there are substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions." To determine whether substantial intercorporate transactions exist, the statute

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[1]The amendment was applicable for taxable years beginning after January 1, 2007, and included all the years in the audit period.

further provided that "the commissioner shall consider and evaluate all activities and transactions of the taxpayer and related corporations" (Tax Law § 211[4][a]).

The Division's technical services memorandum, TSB-M-08(2)C, explained that the requirement of "substantial intercorporate transactions," as used in Tax Law § 211(4)(a), would 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) were from one or more related corporations." This was codified subsequently in the Division's regulations at 20 NYCRR 6-2.3(b)(3)(i)(a)(1) in 2012.

It is indisputable that the payments made by WFMG as royalties for the use or license to use the intellectual property owned by WFMIP constituted "activities and transactions" between the two related corporations (Tax Law § 211[4][a]), which have been recognized as intercorporate transactions for purposes of combined reporting (***Matter of Sherwin-Williams Company v. Tax Appeals Tribunal***, 12 AD3d 112, 115 [3d Dept 2004] ***lv denied*** 4 NY3d 709 [2005]). The technical services memorandum, TSB-M-08(2)C, clearly states that in determining whether substantial intercorporate transactions exist, the transfer of assets such as trademarks and patents must be examined. (***See also*** 20 NYCRR 6-2.3[b][1][vi].)

The same technical services memorandum and regulation note that the substantial intercorporate transactions requirement will be met when 50 percent or more of a company's receipts included in the computation of entire net income are from one or more related corporations (TSB-M-08(2)C; 20 NYCRR 6-2.3[b][3][i][a][1]). Here, it was stipulated that WFMIP received in excess of 50 percent of its total receipts from WFMG for each of the years in the audit period: 56.5078 percent for the tax year ended September 28, 2008; 57.1458 percent for the tax year ended September 27, 2009; and 57.7295 percent for the tax year ended September 26,

2010. In fact, the royalty transactions were the only quantifiable transactions between the companies.

Having satisfied the requirements for combined reporting, it is determined that WFMG and WFMIP should have filed on a combined basis during the audit period. This was not a discretionary choice but a mandatory obligation. Petitioner's arguments for not complying, although rhetorically defensible, are not persuasive.

C. Petitioner's chief argument for relief rests on the language in Tax Law former § 208(9)(o)(2)(A), which mandated the add back of royalty payments except in situations where related corporations filed on a combined basis. This was further clarified in the Division's TSB-M-08(2)C and then codified in 20 NYCRR 6-2.3(b)(3)(i)(a)(1), which, when discussing the requirement of substantial intercorporate transactions, noted that such requirement would be satisfied where 50 percent or more of a corporations's receipts included in the computation of entire net income was derived from a related corporation. Petitioner reasoned that since WFMG had added back the royalty payments no receipts were generated, *ab initio*, for the purpose of WFMIP's calculation of entire net income, i.e., includable in the computation of entire net income. The flaw in this argument is that petitioner overlooks the fact that the receipts were generated on the payment by petitioner for the intangible intellectual property rights gained through the Trademark License Agreement entered into by the parties, effective September 25, 2000. These are facts to which the parties have stipulated. In addition, the receipts were included in WFMIP's federal taxable income during the audit period. Saying the receipts did not exist for purposes of computing WFMIP's entire net income is not a reasonable interpretation of language that permitted excluding such receipts from the computation of entire net income because they were added back by petitioner, presumably after petitioner determined that combined reporting was not warranted.

Despite the statutory provision, petitioner chose to add back the royalty payments to its income for New York corporation franchise tax purposes, prior to any apparent meaningful analysis of whether it might be required to file on a combined basis with WFMIP based upon the substantial intercorporate transactions, i.e., the receipts generated by the royalty payments, which comprised more than 50 percent of WFMIP's receipts during each year of the audit period.

Since these transactions have been found to constitute substantial intercorporate transactions between related corporations, the first analysis should have been whether the two corporations should have filed on a combined basis. Given the analysis above, it is concluded they must. Only if it were concluded that combination was not warranted would the add back requirement be activated.

D. Petitioner makes two arguments that require attention. The first is that the intent of the Legislature expressed in Tax Law former § 208(9)(o)(2)(A) was to ensure that royalty payments to foreign corporations not escape taxation. While this is true, what does not follow is that the only way this could have been achieved was by WFMG adding the payments back to its entire net income. The alternative, expressed as an exception in the first sentence of Tax Law former § 208(9)(o)(2)(A), provided that the two related companies file on a combined basis pursuant to Tax Law § 211(4), if there were substantial intercorporate transactions between the parties. This language mandates that the first inquiry must be whether combined reporting was required. Petitioner correctly notes that the Division does not have absolute authority to require a combined report, but here the facts establish that there were substantial intercorporate transactions, as discussed above. Given that they were related companies engaged in a unitary business, the

Division needed nothing further to require combined reporting. (Tax Law § 211[4][a].) Both the intent of the statute and the Division's interpretation were clear and consistent.

Petitioner's contention that somehow this leads to a distortion of its entire net income or that of WFMIP is in error. Only that portion of WFMIP's income determined by a combined business allocation percentage would be subject to tax (20 NYCRR 4-1.2), and a combined business allocation percentage would only reflect the New York activities of the companies, with other intercorporate receipts eliminated (20 NYCRR 4-1.2; 4-4.8), yielding an accurate reflection of New York income.

E. Petitioner argues that if it is held liable for the additional tax asserted, then the penalty for substantial understatement of tax should be abated. Petitioner believes that its tax returns filed for the audit period were prepared with a reasonable interpretation of the Tax Law and it consistently added back its royalty payments since the enactment of the royalty add-back statute in 2003. Petitioner contends its interpretation was undertaken in good faith and was consistent with the legislative intent.

The Division points out that the add back statute was amended in 2007 to reflect the new mandatory combined reporting statute, thus vitiating petitioner's reasonable interpretation argument. The Division notes that petitioner has not explained how it determined it was not subject to the mandatory combination rules enacted in 2007 or demonstrated how it ascertained its proper tax liability using the royalty add back.

The penalty imposed in the instant matter must be sustained. Tax Law § 1085(k) provides:

> "Substantial understatement of liability. . . If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent of the amount of any underpayment attributable to such understatement. For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds

> the greater of ten percent of the tax required to be shown on the return for the taxable year or five thousand dollars. For purposes of the preceding sentence, the term 'understatement' means the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of the tax imposed which is shown on the return reduced by any rebate (within the meaning of subsection (h) of section one thousand eighty-one). The amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. The tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith."

The Division of Taxation does not have the burden of providing a rationale to prove that penalties should be imposed (***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993). Rather than leaving it to the Commissioner's discretion, the law provides that penalties are to be imposed under specified circumstances and it shall be the burden of the taxpayer to demonstrate that reasonable cause exists for the waiver of penalties.

It has been held that the most important factor in determining whether reasonable cause and good faith exist is the extent of the taxpayer's efforts to ascertain its proper tax liability. (20 NYCRR 2392.1[g][2]; ***Matter of Interaudi Bank***, Tax Appeals Tribunal, April 14, 2011.) While petitioner claims its interpretation was reasonable, it stops short of stating it relied on professional advice, saying only that it filed its returns based on its reasonable interpretation of the Tax Law and that they were prepared in good faith.

Indeed, as the Division noted, petitioner did not make a good faith effort to determine its tax liability after the 2007 amendment, or at least fails herein to disclose that it made such an effort. It mentions no professional advice, informal advice from the Division or the request for a

Division advisory opinion. In light of these failures, it cannot be said that petitioner made a good faith effort (***Matter of Interaudi Bank***).

F. The petition of Whole Foods Market Group, Inc. is denied, and the Notice of Deficiency, dated May 2, 2013, is sustained.

DATED: Albany, New York
July 14, 2016

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE