STATE OF WISCONSIN

TAX APPEALS COMMISSION

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**HORMEL FOODS CORPORATION,** **DOCKET NO. 07-I-17**

Petitioner,

vs. **DECISION AND ORDER**

**WISCONSIN DEPARTMENT OF REVENUE,**

Respondent.

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**BY THE COMMISSION:**

This matter comes before the Commission following a hearing held on March 18, 19 and 20, 2009 before Commissioner Roger W. LeGrand. Petitioner Hormel Foods Corporation ("Hormel") is represented by Attorney Craig B. Fields and Attorney Roberta Mosely Nero of Morrison & Foerster LLP, New York, New York, and Attorney David D. Wilmoth of Quarles & Brady LLP, Milwaukee, Wisconsin. Respondent, the Wisconsin Department of Revenue (the "Department"), is represented by Attorney Mark S. Zimmer and Attorney Julie A. Lotto.

At the hearing, the Commission took sworn testimony and received and entered into evidence the Department's Exhibits 1 through 122 and Hormel's Exhibits A through NN. Prior to the hearing, the parties filed a Stipulation of Facts on March 18, 2009 ("Stip.") and a Stipulation on Exhibits on March 13, 2009 ("Stip. Ex.").

Both parties elected to file post-hearing briefs. Hormel filed its brief on June 1, 2009, the Department filed its brief on July 31, 2009, and Hormel filed its reply brief on September 30, 2009. Having considered the entire record in this matter,

including the sworn testimony, the parties' exhibits and briefs, the Commission finds, concludes, decides and orders as follows:

## FINDINGS OF FACT

1. Hormel Foods Corporation, a Delaware corporation (formerly known as Geo. A. Hormel & Co.) ("Hormel"), has its principal place of business and commercial domicile in Austin, Minnesota. Hormel is primarily engaged in the manufacture and sale of food products. Hormel is engaged in business within and without the State of Wisconsin. Hormel is the parent company of a number of affiliated entities ("Affiliates"). (Stip. ¶¶ 2-6.)

2. Hormel timely filed (and subsequently amended) corporate franchise tax returns with the State of Wisconsin for the fiscal years ended October 31, 1998 and October 31, 1999, which are the franchise tax returns and fiscal years at issue in this appeal (the "returns" and "years at issue"). (Stip. ¶ 15; Ex. 78-81.)

3. After a field audit, the Department timely issued an assessment to Hormel on June 13, 2002 for tax years ending October 31, 1996 through October 31, 1999, inclusive, in the amount of $581,629.76 in tax, plus interest at the statutory rate of twelve percent (the "assessment"). (Stip. ¶ 16; Ex. 1A.)

4. The assessment at issue[1] relates to intercompany adjustments for royalties paid by Hormel to Hormel Foods LLC, a Hormel Affiliate ("Foods LLC"), and intercompany interest expenses for the years at issue, which adjustments total $512,533 in tax. (Stip. ¶ 17.)

[1] Hormel agreed to and paid a portion of the initial assessment, which is not at issue in this appeal.

5. Hormel timely requested redetermination of the portions of the assessment with which it did not agree in a document dated July 26, 2002, and received by the Department on July 29, 2002. (Stip. ¶ 18; Ex. 2.)

6. The Petition for Redetermination was timely denied in full by the Department under a Notice of Action dated December 4, 2006. (Stip. ¶ 19; Ex. 3.)

7. Hormel timely filed a Petition for Review with the Wisconsin Tax Appeals Commission (the "Commission") on January 30, 2007. (Stip. ¶ 20; Ex. 4.)

8. The Commission held a hearing in this matter on March 18, 19 and 20, 2009, where testimony was taken and all exhibits were admitted into evidence. (Transcript ("Tr.") at 1 and 614.)

9. Testifying on Hormel's behalf as fact witnesses in this matter were Mr. Jeffrey M. Ettinger, Mr. Larry D. Gorden, Mr. Kevin C. Jones and Mr. Mark S. Roberts.

10. As of the date of the hearing, Mr. Ettinger was the President, Chief Executive Officer and Chairman of the Board of Hormel and had been employed by Hormel and its affiliates for nearly 20 years. During the years at issue, Mr. Ettinger was Assistant Treasurer and then Treasurer of Hormel. Around November of 1999, Mr. Ettinger was asked to take a general management role in running the Jennie-O Foods organization, a subsidiary of Hormel. (Tr. 18-19.) Mr. Ettinger was the initial President and General Manager of Foods LLC and also a member of the Board of Governors of Foods LLC. He retained both of these positions until he accepted his role at Jennie-O Foods. (Tr. 18-19; Exh. 5.)

11. Mr. Gorden retired from Hormel in April of 2007. He had been employed by Hormel and its affiliates for 37 years at the time of his retirement. From the years at issue until he retired, Mr. Gorden was the Director of Tax for Hormel. As Director of Tax, Mr. Gorden was responsible for all taxes, licenses, permits, regulatory filings and SEC filings for Hormel and its subsidiaries. With regard to Foods LLC, Mr. Gorden was the initial member of the Board of Governors and Vice President and Treasurer during the years at issue. (Tr. 73-74; Exh. 5.)

12. As of the hearing date, Mr. Jones was the Director of Investor Relations at Hormel and had been employed by Hormel and its affiliates for over 30 years. During the years at issue, Mr. Jones was Senior Attorney and Assistant Secretary of Hormel. His responsibilities at that time included overseeing all of the intellectual property law issues, real estate, bankruptcy, credit and collections, negotiable instruments and a few other miscellaneous areas. Mr. Jones was also secretary of several subsidiaries during the years in issue. With regard to Foods LLC, Mr. Jones was the Secretary and General Attorney and was also on the Board of Governors during the years at issue. (Tr. 149-50.)

13. As of the hearing date, Mr. Roberts was Corporate Manager of Regulatory Affairs in the law department of Hormel and had been employed by Hormel and its affiliates for 31 years in various operations and quality control positions. In 1985, Mr. Roberts was the manager of process and quality control for the grocery products division, where he was responsible for all product formulations, labels and regulatory compliance for all grocery division products, both current products and new products in development. In 1988, he was transferred to research and development,

first as the manager of process and quality control - grocery products – research and development, the position he was in during the years at issue, then as manager of technical services and regulatory affairs just prior to taking his current position in 2008. (Tr. 225-30, 246.)

14. Testifying on the Department's behalf as fact witnesses in this matter were Mr. Alex A. Prost and Mr. Steve Aldahl.

15. As of the hearing date, Mr. Prost was a Supervisor of the Department's Field Audit Resolution Unit and had been with the Department for 22 years. Mr. Prost was the large case resolution officer assigned to this matter. (Tr. 539.)

16. As of the hearing date, Mr. Aldahl was a Large Case Corporation Field Auditor and had been with the Department for almost 30 years. Mr. Aldahl conducted an audit of Hormel for time periods subsequent to the years at issue. (Tr. 567-68.)

17. On or about August 6, 1997, Hormel formed Hormel Financial Services Corporation ("HFSC"), a wholly-owned direct subsidiary of Hormel, to provide cash management and other financial services for Hormel and its Affiliates. (Stip. ¶ 7; Ex. 106; Tr. 53.)

18. Setting up HFSC created tax benefits to Hormel. (Tr. 45.)

19. Mr. Ettinger, as Secretary of Hormel, made a presentation to the Board of Directors that characterized HFSC as one of "Three Tax Strategies To Reduce Hormel's Income Taxes." (Tr. 27; Ex. 31, Bates stamp pg. 828.)

20. Mr. Ettinger indicated in that presentation that creating HFSC had the effect to "[m]ove profits from Hormel to HFSC, lowering Hormel's taxable income in non-unitary states." (Ex. 31, Bates stamp pg. 830.)

21. Mr. Ettinger advised Hormel's Board of Directors that by keeping HFSC's nexus only in Minnesota, and having it taxed only in Minnesota and four unitary states, HFSC had a net state tax savings of $1.4 million. (Ex. 31, Bates stamp pgs. 831-836.)

22. The Ernst & Young ("E&Y") Design Document for Foods LLC identified HFSC as a planning technique to generate state tax savings, which saved over $1.3 million annually. (Ex. 33, Bates stamp pg. 851.)

23. The E&Y Tax Planning Meeting agenda materials dated February 2001 identified HFSC as a completed state and local income/franchise tax project. (Ex. 66, Bates stamp pgs. EY-HML-001092-1093.)

24. The E&Y Tax Planning Meeting agenda materials dated February 2001 identified HFSC as producing annual state tax savings of approximately $1.5 million, with a gross state tax rate reduction of 1.5 percent. (Ex. 66, Bates stamp pg. EY-HML-001093.)

25. Mr. Gorden, Hormel's tax director, spearheaded the project to create Foods LLC. (Tr. 51-52.)

26. One of Mr. Gorden's duties was tax planning for Hormel. (Tr. 102.)

27. Mr. Gorden had been contacted quite often by all the major accounting firms proposing the use of an intellectual property company to save taxes. (Tr. 77-78.)

28. Mr. Gorden knew that the structure of an intellectual property company proposed by E&Y would result in tax efficiency or tax savings. (Tr. 82.)

29. Mr. Gorden desired to maximize that tax savings for Hormel. (Tr. 101.)

30. Mr. Gorden had tax planning meetings on an ongoing basis with E&Y. (Tr. 133.)

31. E&Y stated that "Hormel and Ernst & Young, LLP, (E&Y) have entered into a consulting arrangement which focuses on minimizing Hormel's tax liability." (Ex. 74, Bates stamp pg. 153.) Mr. Gorden confirmed that Hormel had entered into a consulting arrangement with E&Y. (Tr. 101.)

32. Mr. Gorden asked E&Y to model the potential tax savings for Foods LLC. (Tr. 106.)

33. A billing to Hormel from E&Y dated February 20, 1998, invoiced for services rendered from December 1, 1997 through January 31, 1998 for "Phase I: Modeling" for "modeling of state ideas" in connection with "the state and local tax project." (Ex. 83, Bates stamp pg. 1017.)

34. A billing to Hormel from E&Y dated March 9, 1998, and incorporating the "Phase I: Modeling" of the February 20, 1998 billing, identified the royalty company as "the next state income tax planning idea." (Ex. 65, Bates stamp pg. EY-HML-000993.)

35. That billing stated that E&Y had presented its conclusions regarding the potential tax savings associated with two planning structures during a

phone conference on February 23, 1998, and again during a monthly meeting between Hormel and E&Y on February 24, 1998. *Id.*

36. The Value Scorecard prepared by E&Y dated March 13, 1998, states that E&Y had "assisted Hormel in implementing a receivables factoring company [HFSC] to reduce Hormel's annual state income taxes," and further stated that "We are working with Hormel to develop a corporate structure which will further reduce Hormel's annual state income taxes." (Ex. 71, Bates stamp pg. EY-HML-SHARED-000114.)

37. Mr. Gorden ordered a transfer pricing study from E&Y to establish royalty rates between Foods LLC and Hormel. (Tr. 63.)

38. E&Y, in its Design Document for Foods LLC, estimated that Foods LLC would "have a taxable income of approximately $189 million, which will be subject to little or no tax in separate return states." (Ex. 33, Bates stamp pg. 847.)

39. E&Y's Design Document for Foods LLC, states that "[i]t is anticipated that the accumulated income and cash from HFSC customer account receivables will be loaned to HFC [Hormel Foods Corporation] at periodic intervals." (Ex. 33, Bates stamp pg. 849.)

40. E&Y's Design Document for Foods LLC states that placing certain intellectual property of Hormel into a single-member LLC would generate savings by shifting income from Hormel to the LLC through a royalty expense charged by the LLC, and E&Y estimated that the result would be a reduction of Hormel's income tax liability by approximately 3.2% of the amount shifted. (Ex. 33, Bates stamp pg. 851.)

41. E&Y provided advice about the structure of Foods LLC and its tax consequences. E&Y did not perform any cost benefit analysis to the transaction other than computing the tax benefits that would result. (Tr. 52, 112.)

42. E&Y was only hired to analyze the tax savings. (Tr. 112.)

43. E&Y billed over $441,000 for work related to Foods LLC's formation and the licensing transaction under the heading of "state and local tax project." (Tr. 59-60, 108; Exs. 70, 83, 103.)

44. The "overall objective" of the new brands company (Foods LLC) was stated by Fred Halvin of the Hormel tax department on April 14, 1998, as "Designing an intellectual property structure that provides state tax savings and reduces downside risks without impacting management reports." (Ex. 67, Bates stamp pg. EY-HML-005839.)

45. The E&Y Project Charter for the Hormel intellectual property company, Foods LLC, states that Hormel's "goal is to minimize its state income tax liability." (Ex. 69, Bates stamp pg. EY-HML-007332; Ex. 74, Bates stamp pg. EY-HML-SHARED-000153.)

46. The E&Y Tax Planning Meeting agenda materials dated February 2001 identified Foods LLC as a completed state and local income/franchise tax project, producing annual state tax savings of approximately $3.5 million, with a gross state tax rate reduction of 2.13%. (Ex. 66, Bates stamp pgs. EY-HML-001092-10933.) E&Y's "Analysis of State Tax Savings/Opportunities" dated December 1, 1999 includes similar language. (Ex. 98, Bates stamp pg. EY-HML-SHARED-006967; Ex. 117-118.)

47. The E&Y Tax Planning Meeting agenda materials dated February 2001 make no mention of business or other cost savings related to Foods LLC besides tax savings. (Ex. 66.) Similarly, the E&Y "Analysis of State Tax Savings/Opportunities" makes no mention of business or other cost savings related to Foods LLC besides tax savings. (Ex. 98, 117-118.)

48. Mr. Gorden used the presentation "State and International Tax Strategies" in making presentations about Foods LLC to Hormel company managers. (Tr. 125; Ex. 31.)

49. The effect of the transaction identified to these managers was to "[m]ove profits from Hormel to Hormel Foods, LLC, again lowering Hormel's taxable income in non-unitary states." (Tr. 126; Ex. 31, Bates stamp pg. 839.)

50. Mr. Gorden was expecting a tax savings of $1.6 million. (Tr. 126.)

51. A projection prepared by the Hormel tax department at Mr. Gorden's direction showed an estimate of $109,526,724 of royalty income to Foods LLC after deduction of R&D division expenses of $10,848,532. (Tr. 132-33; Ex. 38.)

52. The projection prepared by the Hormel tax department shows a "current case" of Wisconsin state tax of $633,374, and a Wisconsin state tax under "3% and 5% royalty payments" of $206,731, for a savings of $426,643 in Wisconsin alone. (Ex. 38, Bates stamp pgs. 940-41.)

53. The projection prepared by the Hormel tax department shows total state tax savings of $3,507,114 and a worst case state tax savings of $1,877,519. (Ex. 38, Bates stamp pg. 945-46.)

54. The projection contained in the Preliminary Design document forwarded by Mr. Halvin of the Hormel tax department to Dan Thibault of E&Y on April 14, 1998 was that at a 3% net royalty, there would be a savings of $2.8 million per year ($1.8 million per year net after federal taxes). (Ex. 67, Bates stamp pg. EY-HML-005839.)

55. E&Y's expectation was that state income tax savings would be approximately $3 million, which Mr. Gorden estimated would be close to the actual results. (Tr. 101; Ex. 74, Bates stamp pg. 153.)

56. Hormel's effective state tax rate prior to setting up Foods LLC was 6.06%; its anticipated effective state tax rate after setting up Foods LLC was 3.93%. (Tr. 111-112; Ex. 32.)

57. Hormel's state tax savings as a consequence of setting up the licensing transaction were also variously estimated at $3,507,113 and $2,943,820. (Ex. 32, Bates stamp pgs. 844, 846.)

58. In E&Y's Design Document, E&Y estimated best case tax savings under a full year of benefit of the structure at $2,968,544, with a $357,874 tax savings specifically determined for Hormel in the State of Wisconsin. (Ex. 33, Bates stamp pg. 858-860.)

59. In E&Y's Design Document, E&Y estimated the expected annual state tax savings from Foods LLC to be approximately $2,476,807. (Ex. 33, Bates stamp pgs. 860-861.)

60. In E&Y's Design Document, E&Y estimated a worst case tax savings of $1,691,811. (Ex. 33, Bates stamp pgs. 861-862.)

61. The E&Y Design Document contains no analysis of savings or cost benefits to Hormel in connection with Foods LLC other than state tax savings. (Ex. 33.)

62. As part of the E&Y documents provided to Hormel in connection with planning for Foods LLC, Elizabeth Christensen of E&Y prepared memoranda dated October 8, 1998 concerning state tax treatment of single-member limited liability companies, foreign pass-through entities, foreign and domestic royalties, and dividends-received deductions. (Ex. 34-37; Tr. 110; Ex. 57, Response to Interrogatory No. 4.)

63. The E&Y Project Charter for the Hormel intellectual property company (Foods LLC) states that "[w]e will work with Hormel to identify the best structure for the new entity, including other operations that may be transferred to give it substance…." (Ex. 69, Bates stamp pg. EY-HML-007333.)

64. An internal E&Y document entitled "Hormel Design Phase" states the intent to "Identify whether R&D function can be transferred to Intellectual Property Company," and "Identify other functions that may be transferred to the new entity." (Ex. 72.)

65. A "Preliminary Design" document sent by Mr. Halvin of Hormel's tax department to Mr. Thibault of E&Y on April 14, 1998 recommended that Foods LLC be set up as a single-member limited liability company, with R&D and Engineering R&D Departments in it, with a notation that they were "[s]till exploring other options." Under "Rationale" in this document, it was noted that "[s]tates have attempted to ignore entities without substance" and "R&D strengthens substance by nature of business." (Ex. 67, Bates stamp p EY-HML-005839.)

66. In a presentation to Hormel's Board of Directors, Mr. Ettinger advised that they should "[p]ut Hormel's existing R&D and Engineering research group into the new sub [Foods LLC]" to give Foods LLC substance. (Ex. 31, Bates stamp pg. 838.)

67. Foods LLC was organized under the laws of the State of Minnesota on July 13, 1998. From July 13, 1998 through August 30, 1998, Hormel was the sole member and owned 100% of Foods LLC. On August 30, 1998, Hormel transferred its membership interest in Foods LLC to Hormel's wholly-owned subsidiary Hormel Foods International Corporation ("International"). International was the sole member and owned 100% of the membership interest in Foods LLC during the years at issue. (Stip. ¶¶ 8, 12.)

68. On August 28, 1998, Mr. Ettinger was elected President and General Manager, Mr. Gorden was elected Vice President and Treasurer, and Kevin C. Jones was elected Secretary and General Attorney of Foods LLC. (Ex. 5.)

69. Mr. Gorden, Hormel's tax director, continued to act as Vice President and Treasurer of Foods LLC through at least 2002. (Exs. 16, 18.)

70. The plan of restructuring was produced by E&Y at Hormel's request. (Tr. 114.)

71. E&Y's plan of restructuring was the basis for the bullet points in the draft Board resolution approving the plan, although Tom Leake, Hormel's corporate secretary, deleted two of E&Y's bullet points. (Tr. 58, 113-15, 161-63; Ex. 44.)

72. On July 27, 1998, then-Treasurer Ettinger made a presentation to the Hormel Board of Directors, entitled "State and International Tax Strategies," which

recommended a transaction that would transfer the intellectual property of Hormel to Foods LLC and a license of the intellectual property back, with a payment of royalties. Mr. Ettinger characterized Foods LLC as one of "Three Tax Strategies to Reduce Hormel's Income Taxes." Mr. Ettinger further stated that the effect of creating Foods LLC would be to "[m]ove profits from Hormel to Hormel Foods LLC, again lowering Hormel's taxable income in non-unitary states." Mr. Ettinger advised Hormel's Board that the net state tax savings was estimated at $1.6 million. (Tr. 27-28; Ex. 31, p. 2 and Bates stamp pg. 838-39.)

73. Mr. Ettinger did not provide Hormel's Board with any estimates of business savings or increased profits for the company. (Tr. 58.)

74. Other than the anticipated tax savings, Hormel did not analyze the costs or benefits of these planned transactions, either before or after the formation of Foods LLC while Mr. Ettinger was President. (Tr. 58; 206.)

75. Mr. Jones represented in writing to a third party, Todd Doyle ("Doyle"), an officer of Family Restaurants, Inc., on September 4, 1998, that the objective of the royalty transaction was "to realize a permanent, state tax savings each year," with the intent of communicating to Mr. Doyle that the transaction between Hormel and Foods LLC was for tax purposes. (Tr. 157-58; Ex. 42, Bates stamp pg. 1636.)

76. The writing to Mr. Doyle further stated "Savings are a result of reducing ____ taxable income in all states and ____ having taxable income in only a limited number of states." (Omissions in original). (Ex. 42; Bates stamp pg. Hormel 01636.)

77. Mr. Ettinger was not aware of any particular problems with regard to developing or protecting new products or new intellectual property before Foods LLC was established. (Tr. 62.)

78. On July 27, 1998 the Hormel Board of Directors approved: (1) the transfer of certain of Hormel's patents, patent pending applications, know-how, trademarks, service marks and copyrights (collectively, the "Intellectual Property") to Foods LLC; (2) the transfer of the equipment and personnel utilized in research and development and engineering research and development to Foods LLC; and (3) the license of the Intellectual Property by Foods LLC to Hormel. (Stip. ¶ 9; Exh. 45.)

79. Hormel's Board stated that Foods LLC was to be operated in order to contribute to Hormel by the following means: (1) as a separate cost center allowing valuation of the Intellectual Property and the possible revenues to be obtained from that value; (2) allowing comparison of performance to comparable entities; (3) providing closer management of the use and protection of the Intellectual Property; (4) providing a focus on the Intellectual Property that would allow a more aggressive approach to future alliances, partnerships or joint ventures; (5) providing for a closer relationship between product and brand development including an enhanced emphasis on the exploitation of brands as new products were created; and (6) providing reductions in the cost of doing business, including tax savings. (Exh. 45.)

80. Hormel assigned the Intellectual Property to Foods LLC effective August 30, 1998. (Stip. ¶ 10; Exhs. 86, 87.)

81. As a result of that transfer, Foods LLC became legal owner of the Intellectual Property. (Jones Testimony, Tr. 158-59, 164-65; Cotter Testimony, Tr. 494-95, 498; Exhs. 86, 87.)

82. Also on August 30, 1998, Hormel licensed from Foods LLC the Intellectual Property under two license agreements, an Exclusive License Agreement relating to the patents and know-how and an Exclusive Intellectual Property License Agreement relating to the trademarks and copyrights (together, the "License Agreements"). (Stip. ¶ 11; Exhs. 19, 20.)

83. Under the License Agreements, Hormel agreed to pay Foods LLC specified royalties that varied based upon the category of product. (Stip. ¶ 11; Exh. 20, Schedule C – Schedule of Royalty Rates By Commodity.)

84. The royalty rates were determined through a study conducted by E&Y at the request of Mr. Gorden. (Tr. 36, 87-88.) The study resulted in a report entitled "Hormel Foods Corporation, Analysis of Intercompany Transactions Under Internal Revenue Code § 482." (Exh. 43.) The report utilized the principles of the federal transfer pricing rules, specifically including Treas. Reg. § 1.482, to arrive at "a reasonable range of consideration for the intercompany license of intangible property," or a range of royalty rates that could be charged between two related companies that would be arm's-length rates (i.e., rates that would be charged between two unrelated parties). (Exh. 43 at 1.)

85. The report concluded that a royalty rate of from one to five percent of net sales would be an arm's length royalty rate. (Exh. 43 at 41.)

86. E&Y provided Hormel with a list of royalty rates broken up by commodity, to reflect the differences in the value of the various products sold by Hormel, that when averaged together fall within the one to five percent range specified by E&Y in the report as an arm's length rate. (Tr. 87-88.)

87. The License Agreements were drafted by Mr. Jones, who was then the senior attorney for Hormel. (Tr. 149, 168.)

88. Foods LLC was not represented by independent counsel (*i.e.*, counsel not employed by Hormel) in connection with the License Agreements. (Tr. 186-187.)

89. On August 30, 1998, Hormel transferred its membership interest in Foods LLC to Hormel's wholly-owned subsidiary Hormel Foods International Corporation ("International"). International owned 100% of the membership interest in Foods LLC during the fiscal years ending October 31, 1998 and October 31, 1999, and was the sole member during that period. (Ex. 120 shows the corporate relationships.) (Stip. ¶ 12; Ex. 10.)

90. Mr. Jones was responsible for handling intellectual property filings both before and after the formation of Foods LLC. (Tr. 43.)

91. Mr. Gorden did not handle any day-to-day operations for Foods LLC. (Tr. 144-145.)

92. The Beanstalk Group was a licensing representative retained by Hormel before Foods LLC was formed, and continued to represent Hormel after Foods LLC was formed through at least April of 1999. (Tr. 199-200; Ex. 27.)

93. Under an Administrative Services Agreement dated August 30, 1998 between Foods LLC and Hormel, Hormel provided: all accounting, payroll, auditing, and financial reporting services for Foods LLC; all data processing and management reporting for Foods LLC; all recruiting, interviewing, employment administration, and fringe benefit administration for Foods LLC; all risk management functions relating to workers compensation, general liability, and fixed assets; all reporting requirements of federal, state or local governments, including maintaining operating licenses and permits, legal and tax consulting, tax planning and the preparation of federal, state and local tax returns for Foods LLC; all legal services as Foods LLC required; and any other administrative services as the Board of Governors of Foods LLC requested. As compensation, Foods LLC paid Hormel a monthly fee of $10,000 plus reimbursement for legal services at cost plus ten percent and for all of Hormel's out-of-pocket expenses incurred in performance of these services. (Ex. 7, pgs. 1-2.)

94. The Administrative Services Agreement specified that "any of the employees of Hormel Foods which are rendering services on behalf of [Foods] LLC hereunder shall remain employees of Hormel Foods . . . ." Ex. 7, p. 2.

95. In a filing before the U.S. Patent and Trademark Office dated December 1, 1998, Hormel represented that it "is the owner of all rights and the good will associated with respect to the following trademark registrations and applications," with a list of the trademark registrations and applications that had been transferred to Foods LLC in August of 1998. (Tr. 208; Ex. 82, Bates stamp pgs. 796, 799.)

96. Mark Roberts, Manager of process and quality control GP-R&D both before and after Foods LLC was created, understood his instructions from Forrest Dryden, Vice President of R&D, to be that he was to do nothing different from what he had done before. (Tr. 230, 301-2; Ex. 22.)

97. Mr. Roberts testified that the licensing agreement between Hormel and Foods LLC presented him a base to be able to conduct product cuttings from all divisions, which he had been trying to do since 1988. (Tr. 250, 255, 289-90.)

98. These controls were already in place for Hormel's grocery products division, which covered all of Hormel's shelf-stable foods, including SPAM, Mary Kitchen hash and Dinty Moore beef stew, as well as frozen foods, microwaveable frozen sandwiches and the like. (Tr. 230, 234-35.)

99. Any division other than grocery products could have been doing testing as grocery products did to maintain consistency and uniformity without formation of the LLC. (Tr. 300.)

100. New products could be originated anywhere, which was both the case before and after Foods LLC was set up. (Tr. 299.)

101. Quality control was important to maintain the brand names and to maintain consistency in quality and safety, both before and after Foods LLC was set up. (Tr. 299-301.)

102. The R&D group was in the same facility before and after formation of Foods LLC, with about 100 employees, since 1977. (Tr. 261.)

103. Mr. Roberts was still answering to the Vice President of R&D before and after Foods LLC was set up, and he did not get a new boss. (Tr. 303, 306.)

104. A June 29, 1998 email to Mr. Ettinger and Mr. Gorden stated that when they met with the R&D employees about the spinoff of Foods LLC, they should "stress the retention of benefits, seniority, personnel moves, and continuation of current divisional structure." (Ex. 11.)

105. Hormel management did not want to change to whom the engineering group reported in functional terms after those employees were moved from Hormel to Foods LLC. (Tr. 64.)

106. Hormel management did not want to change to whom the food group reported in functional terms after those employees were moved from Hormel to Foods LLC. (Tr. 64.)

107. Other than some of the R&D employees who were moved from Hormel to Foods LLC having a change in their paycheck cycle, there was no change in their wages or benefits. (Tr. 65.)

108. No employee actually changed offices or locations after Foods LLC was set up. (Tr. 145-146.)

109. The pilot plant was in the R&D building both before and after Foods LLC was set up, as were the chemistry lab, microbiology labs, the labs for testing pesticide residue and oxygen diffusing through plastic, the pathogen lab, the testing booths, and the kitchens. (Tr. 298.)

110. The R&D building and real estate were not transferred to Foods LLC. (Tr. 30.)

111. No R&D employees were laid off as a result of Foods LLC being formed. (Tr. 65.)

112. There was no intent to sell off the R&D unit, or to sell any of Hormel's intellectual property. (Tr. 99.)

113. Hormel developed and owned a number of patents after the transfer of the Intellectual Property to Foods LLC. (Ex. 54, Response to Interrogatory No. 14.)

114. Mr. Gorden did not know if there were any cost reductions that resulted from the license transaction with Foods LLC other than the reduction of tax liability. (Tr. 127-128.)

115. The accounting for Foods LLC was set up in a manner so as "not to disturb the current operating P & L's," and would have "[n]o impact on current management reports." (Ex. 67, Bates stamp pgs. EY-HML-005833, 5836, 5839.)

116. According to Alex Prost, the Department's Field Audit Resolution Unit Supervisor, Hormel's payment of royalty expenses caused a shifting of income away from Hormel and into Foods LLC, without a matching proportionate increase in Foods LLC's expenses. (Tr. 553-55.)

117. For the fiscal year ending October 31, 1998, the payment of $20,901,554 in royalties (for the short period of August 30, 1998 through October 31 1998) by Hormel to Foods LLC reduced Hormel's net profit before tax to $166,657,113. (Stip. ¶ 13; Ex. 100, Bates stamp pg. 180.)

118. For the fiscal year ending October 31, 1999, the payment of $116,050,129 in royalties by Hormel to Foods LLC reduced Hormel's net profit before tax to $53,250,570. (Stip. ¶ 13; Ex. 101, Bates stamp pg. 185.)

119. Before and after the formation of Foods LLC, Hormel had product brand managers in its marketing subgroups, with about a dozen product brand managers in the grocery products group. A product brand manager was responsible for advertising for his particular brands and was involved in interacting with the Hormel sales force to make sure that promotional initiatives and new product initiatives were successful. (Tr. 48-49.)

120. Foods LLC did not have any product brand managers and did not have employees who were solely responsible for advertising. (Tr. 50.)

121. Both before and after the formation of Foods LLC, Hormel retained decision-making control over label submissions, advertisements, patent filings, trademarks, packaging, graphics, and new product development. (Tr. 67, 180, 200, 277-78, 299-300.)

122. There was no employee of Foods LLC whose specific job was to monitor trademark or patent infringement by third parties. Mr. Jones of the Hormel law department was responsible for monitoring trademark or patent infringement by third parties. (Tr. 67, 182.) Hormel field representatives were asked to monitor stores for trademark infringement, among other things. (Tr. 68.)

123. Foods LLC did not have its own accounting department, tax department (other than Mr. Gorden) or legal staff. (Tr. 69, 115, 205; Ex. 48.)

124. The Hormel legal department did not charge for services rendered to Foods LLC to defend trademarks, etc. (Tr. 205; Ex. 48.)

125. All requests for legal services or action by Foods LLC had to be initiated through Hormel's legal department. (Tr. 69, 202; Ex. 51.)

126. Any outside counsel doing work on behalf of Foods LLC would be paid by the Hormel law department, and the cost would be charged against Foods LLC. (Tr. 201; Ex. 51.)

127. Hormel set up a stock award program for Foods LLC employees who developed an invention, and another award if a patent was ultimately issued. The stock awarded was shares of Hormel. (Tr. 22, 44-45.)

128. Neither Mr. Ettinger nor Mr. Gorden was involved in setting the royalty rates between Foods LLC and Hormel, which were computed by E&Y. Tr. 62-63, 99.

129. There were not separate royalty rates for patents, trademarks and copyrights, just a single royalty rate schedule for all of the intellectual property. (Tr. 179-180.)

130. Foods LLC received no royalties from any unrelated third party during the years at issue. (Ex. 58, Responses to Interrogatory Nos. 2-3.)

131. Hormel was unable to locate any assignments by Hormel to Foods LLC of any licenses with unrelated third parties that were in effect during the Audit Period. (Ex. 58, Response to Interrogatory No. 8.)

132. Internal accounting charges for intellectual property royalties could have been made on an interdivisional basis as opposed to setting up a separate entity. (Tr. 46-47.)

133. It was possible to have set up a formalized approach for review of product submissions and product cuttings internally within Hormel, without setting up a separate entity. (Tr. 22, 45.)

134. Persons from Foods LLC who were designated to be point persons for new product development and consistency could have been so designated within Hormel without setting up a separate entity. (Tr. 46.)

135. Two expert witnesses testified for Hormel, Professor Richard Pomp and Dr. Brian Cody. (Tr. 309-440 and 586-609.)

136. The parties agreed that Professor Pomp was qualified to testify as an expert in the field of tax policy and that Dr. Cody was qualified to testify as an expert in the field of economics in general and, in particular, the field of transfer pricing (Stip. ¶¶ 8 and 21.)

137. Professor Pomp gave his opinion that the deduction taken by Hormel for the payment of royalties to Foods LLC was appropriate. (Tr. 398.)

138. Dr. Cody gave his opinion that it was reasonable for Foods LLC to charge royalties to Hormel and that the royalty rates of 1% to 5% satisfied the arm's-length standard. (Tr. 336-339, 352-358.)

139. Dr. Cody testified that in assessing economic substance of a license transaction, one would look at the agreement as a whole. To the extent there are differences in specific terms, then judgment would be used to determine whether those specific terms are enough to reject the agreement. (Tr. 359-60.)

140. None of the comparable license agreements identified by E&Y had the wide range of commodities contained in the Hormel license agreements. (Tr. 362, 376; Ex. 90-96, 104-105.).

141. Dr. Cody did not perform a transfer pricing study for Hormel. (Tr. 367.)

142. E&Y utilized the comparable uncontrolled transaction ("CUT") method in its transfer pricing study for Hormel. (Tr. 367.)

143. Reliability of the CUT method is dependent on which comparables are selected. (Tr. 368.)

144. If the comparable does not match up with the agreement that is being tested, the IRC sec. 482 regulations require consideration of adjustments to account for that. (Tr. 368; Reg. sec. 1.482-1(d)(2).)

145. The sec. 482 regulations also provide that if adjustments for material differences between the comparable agreement and the tested agreement cannot be made, the reliability of the analysis will be reduced. (Tr. 368; Reg. sec. 1.482-1(d)(2).)

146. E&Y made no adjustments of any kind in their analysis of the comparable agreements. (Tr. 369, 372.)

147. Dr. Cody testified that one would expect a license with an exclusivity clause to include a clause for the licensee to use its best efforts to promote products bearing the mark, but no such best efforts clause was included in Hormel's license agreements. (Tr. 360-61.)

148. The Hormel licenses of the Intellectual Property from Foods LLC include neither a minimum royalty clause nor a "best efforts" clause or any minimum sales requirements. Exs. 19, 20.

149. Dr. Cody did not perform his own set of computations regarding the royalty rates and the profitability of the various commodities involved in the Hormel licenses. (Tr. 363-64.)

150. Mr. Gorden was unable to recall whether there was any adjustment made to the royalty rates over the years based on experience. (Tr. 128.)

151. The relationship between Hormel and Foods LLC created a circular flow of funds. The royalties were loaned by Foods LLC to HFSC, which in turn loaned them back up to Hormel (generating an additional interest deduction). Then, Foods LLC distributed the royalty funds, after expenses, to Hormel's subsidiary, International, which in turn dividended the funds back up to Hormel. (Ex. 120.)

152. Hormel paid royalties under the licenses to Foods LLC in the amounts of $20,901,554 for the fiscal year ended October 31, 1998 and $116,050,129 for the fiscal year ended October 31, 1999. (Stip. ¶13.)

153. Hormel paid royalties under the licenses to Foods LLC in the amounts of $123,052,121 for the fiscal year ended October 31, 2000, $131,956,089 for the fiscal year ended October 31, 2001, $119,493,840 for the fiscal year ended October 31, 2002, and $132,798,998 for the fiscal year ended October 31, 2003. (Tr. 568-69; Exs. 115, 116.)

154. HFSC performed cash management services on behalf of Hormel and its Affiliates, which included daily cash sweeps of the Affiliates' available cash. If a company had a surplus of income over expenses for the day, cash was loaned to HFSC which, in turn, would loan it, as needed, to another company or invest it with third parties. Foods LLC participated in the cash management system. (Stip. ¶ 14; Exs. 8, 9.)

155. When Foods LLC collected royalties, the funds would then be held and managed by HFSC. (Tr. 55.)

156. At the end of each month, the royalty accounts of amounts due from Hormel to Foods LLC were paid and zeroed out, through HFSC. (Tr. 143.)

157. After Foods LLC received the cash from Hormel, it was wired to HFSC for investing. (Tr. 143.)

158. That transaction created a note receivable on the Foods LLC books for HFSC, which would be cleared by a dividend distribution. (Tr. 64-65, 140-43; Ex. 67, Bates stamp pg. EY-HML-005834.)

159. As of October 31, 1999, Foods LLC had a loan balance of over $90 million loaned to HFSC, and HFSC had a loan balance of over $55 million loaned to Hormel. (Tr. 541-46; Ex. 119, p. 1-2.)

160. As of October 31, 2000, Foods LLC had a loan balance of over $159 million loaned to HFSC, and HFSC had a loan balance of $247 million loaned to Hormel. (Tr. 541-46; Ex. 119, p. 1-2.)

161. Foods LLC also made rolling loans directly to Hormel during the Audit Period. (Ex. 54, Response to Interrogatory No. 25.)

162. A distribution or dividend of $250 million was authorized and paid from Foods LLC to International on October 3, 2002. (Tr. 120-21; Ex. 23.) International dividended the same amount, $250 million, to Hormel on October 8, 2002. (Tr. 193; Ex. 107.)

163. A distribution of $149 million was authorized and paid from Foods LLC to International on October 24, 2003. (Tr. 121; Ex. 24.) International paid a dividend of the same amount, $149 million, to Hormel on November 24, 2003. (Tr. 193-94; Ex. 108.)

164. A third distribution of $100 million was authorized and paid from Foods LLC to International on November 1, 2004. (Tr. 121-22; Ex. 126.) International paid a dividend of the same amount, $100 million, to Hormel on November 24, 2004. (Tr. 194-95; Ex. 109.)

165. Foods LLC had no income with which to pay a dividend or a distribution other than the royalties received from Hormel, over any other expenses. (Tr. 122, 191.)

166. On October 30, 2004, Foods LLC declared a dividend distribution of certain contractual rights to International, namely, "[T]he right to disapprove any assignment, transfer, sale or any other type of disposition of all trademarks and trade names, or any part thereof, owned by Hormel Foods LLC as of October 30, 2004." (Tr. 122-23; Ex. 25, Bates stamp pg. Hormel 01197.)

167. Mr. Jones was unable to recall why those contractual rights were transferred to International, or whether anything was received in exchange for those contractual rights being transferred. (Tr. 192.)

168. Hormel discontinued payment of royalties to Foods LLC in 2004. (Tr. 90-91.)

169. The licenses were terminated effective January 28, 2004. (Tr. 208-10; Ex. 64.)

170. The licenses were terminated because the licenses were no longer desired by Hormel and its Affiliates. (Tr. 209.)

171. Mr. Jones believed that he drafted the termination agreement, and there was no other attorney involved in that termination outside of Hormel's law department. (Tr. 209-10; Ex. 64.)

172. The intellectual property remained in Foods LLC after the termination of the license. (Tr. 117.)

173. Foods LLC then was moved from being a subsidiary of International to being a direct subsidiary of Hormel through a dividend of International's membership interest in Foods LLC signed by International's Board of Directors and countersigned by Hormel. (Tr. 117, 197; Exs. 46, 110.)

174. The 2004 assignment of its Foods LLC membership interest by International was made at the direction of Hormel management in conjunction with a restructuring of its business. (Tr. 118; Ex. 68, Bates stamp pg. EY-HML-007023.)

175. Foods LLC has never filed a Wisconsin income or franchise tax return. (Tr. 117.)

176. Professor Thomas Cotter testified as an expert for the Department of Revenue. (Tr. 441-537.)

177. The parties agreed that Professor Cotter was qualified to testify as an expert in the field of intellectual property, including patents, trademarks and copyrights. (Stip. Ex. ¶ 9.)

178. Professor Cotter gave his opinion that from an intellectual property standpoint there was no business purpose or economic purpose for the transfer of intellectual property to Foods LLC and then receiving it back other than tax avoidance. (Tr. 488-492.)

## ISSUE PRESENTED

Was Hormel entitled to claim deductions for royalties it paid to Foods LLC for the use of certain intellectual property during the years at issue? (Stip. ¶ 1.)

## CONCLUSION OF LAW

The Department properly disallowed the deductions claimed by Hormel at issue in this matter because the underlying transactions lacked economic substance and a valid business purpose and were entered into primarily for the purpose of tax avoidance.[2]

## DISCUSSION

In 1998, Hormel transferred its ownership of certain intellectual property to its subsidiary Foods LLC, and the two entities then entered into two exclusive License Agreements under which Hormel paid royalties to Foods LLC for the use of the intellectual property. Hormel deducted the royalties it paid to Foods LLC as ordinary and necessary business expenses on Hormel's Wisconsin returns for the years at issue. Following a field audit, the Department disallowed the deductions and issued the assessment that is the subject of this appeal.

Assessments made by the Department are presumed to be correct, and the burden is on the petitioner to prove by clear and satisfactory evidence in what respects the Department erred in its determination. *Edwin J. Puissant, Jr. v. Wis. Dep't of Revenue*,

[2] In its initial post-hearing brief, Hormel also argued that the disallowance of the claimed deductions results in an "unconstitutional taxation of income that has no connection to the activities of Hormel in Wisconsin, . . . ." (Hormel Brf. at 51.) The Department responded that it is seeking only to tax Hormel's Wisconsin income using a three-factor apportionment formula of the type approved by the Supreme Court. (Dept. Brf. at 70, *citing Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 170 (1983).) Hormel's initial argument was underdeveloped and Hormel did not respond to the Department's response in its Reply. Consequently, we do not consider Hormel's constitutional argument in reaching this decision.

Wis. Tax Rptr. (CCH) ¶ 202-401 (WTAC 1984); Wis. Stat. § 77.59(1). Tax exemptions, deductions, and privileges are matters of legislative grace and will be strictly construed against the taxpayer. *Fall River Canning Co. v. Dep't of Taxation*, 3 Wis. 2d 632, 637, 89 N.W.2d 203 (1958). In this case, Hormel bears the burden of proof and the deductions it seeks must be strictly construed.

**1. Wisconsin Law**

Wisconsin generally follows federal law in income tax matters. Under Section 162 of the Internal Revenue Code (the "IRC"), a business may only deduct expenses that are "ordinary and necessary." IRC § 162. Following a field audit of the years at issue, the Department disallowed Hormel's claimed royalty deductions and issued this assessment to Hormel pursuant to Wis. Stat. § 71.30(2), which states:

> In any case of 2 or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, whether or not affiliated, and whether or not unitary) owned or controlled directly or indirectly by the same interests, the secretary or his or her delegate may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses, if he or she determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses.

Wis. Stat. § 71.30(2).

Applicable Wisconsin statutes and regulations do not provide additional relevant guidance in interpreting § 71.30(2), Stats., and Wisconsin courts have not squarely addressed what test the Department should use in deciding whether to object to or respect transactions between related entities under Wis. Stat. § 71.30(2). However,

Wisconsin courts and the Commission have addressed similar issues in other cases, and various federal cases and cases from other jurisdictions are also instructive.

Wisconsin courts generally have applied a version of the "sham transaction" doctrine, which provides that transactions will only be recognized for tax purposes if they have economic substance and a valid business purpose other than avoiding taxes. In *Wis. Dep't of Revenue v. Sentry Financial Services Corp.*, 161 Wis. 2d 902, 914, 469 N.W.2d 235 (Ct. App. 1991), the Court of Appeals dealt with the Department's challenge of a taxpayer's claimed nonrecognition of gain on a sale between related entities. The Court held that non-recognition would apply "as long as the transfer serves a valid business purpose and was not done to avoid or evade taxation." *Id.* In *Wall v. Dep't of Revenue*, 157 Wis. 2d 1, 458 N.W.2d 814 (Ct. App. 1990),[3] the Court of Appeals addressed allocations of a partner's share profits and loss under a partnership agreement. The Court stated that such allocations must serve a bonafide business purpose and would be disregarded if they lack substantial economic effect. *Id.*

In *Kimberly-Clark Corp. v. Wis. Dep't of Revenue*, Docket No. 92-I-306, Wis. Tax Rptr. (CCH) ¶ 400-056 (WTAC April 12, 1994), the Commission noted that a corporate entity is not to be lightly disregarded, as cited by Hormel. (Hormel Brf. at 40-41.) The Department argues that it is not attempting to disregard an entity; rather, it is simply denying a deduction based on an intercompany transaction between two related entities. (Dept. Brf. at 50.) In response, Hormel argues that "there is no practical distinction between disregarding Foods LLC and disregarding the transactions

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[3] *rev'd on other grounds, Village of Trempeleau v. Mikrut*, 273 Wis. 2d 76, 96, 681 N.W.2d 190 (2004).

surrounding the establishment and operations of Foods LLC." (Hormel Brf. at 41.) We agree with Hormel that, in this case, the Department's distinction is so slim that it barely exists. However, Hormel's argument proves too much, because it indicates that the business purpose of Foods LLC was virtually indistinguishable from Hormel's royalty payments and the related deductions.

While *Kimberly-Clark* may be relevant here, it is also clearly distinguishable on other grounds. The corporation at issue was a foreign sales corporation ("FSC") under IRC §§ 921-927, and the Commission's decision turned on a number of considerations specific to that type of entity that are not present here. Consequently, while Wisconsin law provides some guidance here, federal law and certain cases from other jurisdictions provide a more thorough discussion of these issues.

**2. Federal Law**

Federal courts have developed a number of closely related and sometimes overlapping doctrines that can be applied to negate claimed tax benefits in tax cases. These doctrines are often labeled differently by different courts. Frankly, the language used in these opinions is often inscrutable. In this case, we label the doctrine applied herein as the "sham transaction" doctrine, although the "economic substance doctrine" provides a more accurate description.

While not yet openly applied in Wisconsin, the economic substance doctrine has a long history in federal case law. The origin of this doctrine is the United States Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). The taxpayer in *Gregory* desired to sell stock shares held by a subsidiary. In order to

minimize her tax liability, the taxpayer had the stock that was to be sold transferred to her by way of a tax-free reorganization using a newly created and separate corporate entity. After using the separate corporate entity in this manner, the taxpayer quickly dissolved it. Once the taxpayer owned the stock directly, she sold the shares, resulting in a substantially lower income tax assessment than if the original corporation had sold the shares.

The Supreme Court dismissed the transaction as "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else," noting that the entity was disbanded immediately following the sale of the stock. *Id.* at 470. Although the use of the new entity followed the letter of the federal statute, which allowed for tax-free corporate reorganizations, the transaction was rejected as a "sham" because it had no relationship to the legislative intent. The federal statute was passed to allow corporations to transfer assets "in pursuance of a plan of reorganization," not to facilitate tax avoidance. *Id.* at 469. The Court stated that while taxpayers have a legal right to act in a way that will diminish their tax burden, they may not do so by creating a business entity with no other business or corporate purpose, but whose "sole object and accomplishment [is] ... the consummation of a preconceived plan" to avoid taxation. *Id.*

The most direct and succinct statement of the economic substance doctrine by the Supreme Court occurs in *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978). In that case, the taxpayer bought a building from a bank, financed mostly by a mortgage, and leased the building back to the bank for rent equal to the taxpayer's payments of principal and interest on the loan. The Supreme Court upheld the transaction, setting forth the

following standard to determine when a transaction should be respected for tax purposes:

> [W]here ... there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

*Id.* at 583-84.

The Federal appellate courts have differed in their application of the economic substance doctrine. One version of the standard requires that for a transaction to be disregarded for tax purposes there must be both no business purpose other than to obtain tax benefits and no economic substance to the transaction. *See, Horn v. Comm'r*, 968 F.2d 1229, 1237 (D.C.Cir. 1992); *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985). Other circuits indicate they will disregard a transaction if there is either no business purpose or no economic substance. *See, Coltec Industries Inc. v. U.S.*, 454 F.3d 1340, 1355 (Fed.Cir. 2006) ("While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."), *cert. den'd*, 549 U.S. 1206 (2007). Still other circuits will overlook the taxpayer's motivation and focus primarily on whether the "transaction had any practical economic effects other than the creation of income tax losses." *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir. 1988), *abrogation on other grounds recognized by Keane v. Comm'r*, 865 F.2d 1088 (9th Cir. 1989); *see, also, James v. Comm'r*, 899 F.2d 905, 908-09 (10th Cir. 1990).

Alternatively, several circuits have held that business purpose and economic substance are related factors that "inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM Partnership v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998), *cert. den'd*, 526 U.S. 1017 (1999); *see, also, IES Indus., Inc. v. U.S.*, 253 F.3d 350, 353-54 (8th Cir. 2001) (stating, "we do not decide whether the [economic substance doctrine] requires a two-part analysis because we conclude that the [transaction] here had both economic substance and business purpose"); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001); *Pasternak v. Comm'r*, 990 F.2d 893, 898 (6th Cir. 1993).[4]

The United States Tax Court has held that business purpose and economic substance must be present for a transaction involving royalties between related entities to be sustained. In *Medieval Attractions N.V. v. Comm'r*, T. C. Memo 1996-455, 72 TCM 924 (T.C. Memo 1996), the I.R.S. challenged royalty payments between related companies, and the Tax Court upheld the denial of deductions for the royalties because there was a lack of business purpose and a lack of economic substance to the transactions.

**3. Other States**

The economic substance doctrine is also recognized in tax cases in other states. *See, e.g., Baisch v. Dep't of Revenue*, 850 P.2d 1109, 1113 (Ore. 1993). Three recent Massachusetts cases, *Sherwin-Williams Co. v. Comm'r of Revenue*, 778 N.E.2d 504 (Mass. 2002), *Syms Corp. v. Comm'r of Revenue*, 436 Mass. 505, 765 N.E.2d 758 (Mass. 2002), and

[4] Similarly, at least one court has stated that there is no distinction to be made between the entity and transaction in question, because the test "is in fact a unitary test—whether the 'sham' be in the entity or the transaction—under which the absence of a nontax business purpose is fatal." *ASA Investerings Partnership v. Comm'r*, 201 F.3d 505, 512 (D.C. Cir. 2000) (footnote omitted).

*The Talbots, Inc. v. Comm'r of Revenue*, Mass. Tax Rptr. (CCH) ¶ 401-268 (Mass. App. Tax Bd. Sep. 29, 2009), provide a particularly helpful discussion of federal law because they applied the economic substance doctrine to subsidiaries created in a similar manner to the one at issue here. In these cases, the Massachusetts Commissioner of Revenue disallowed the taxpayers' deductions of royalty payments made to wholly-owned subsidiaries, and the taxpayers appealed.

In *Sherwin-Williams*, the Supreme Judicial Court of Massachusetts applied the sham transaction doctrine and ruled in the taxpayer's favor based on the Court's determination that the transactions had economic substance and a business purpose. *Sherwin-Williams*, 778 N.E.2d at 517-19. The Sherwin-Williams Company had transferred its trade names, trademarks, and service marks to two wholly-owned subsidiaries, which then received royalties in return for leasing most of the marks back to the Sherwin-Williams Company by way of nonexclusive contracts. The entities also engaged in independent economic business activity, which included leasing marks to other companies, investing the earned royalties independent of the Sherwin-Williams Company, and hiring independent employees. The new entities also bore the risk of owning the marks. The parent company subsequently took a deduction for the royalties as ordinary and necessary business expenses.

The Court explained that the economic substance doctrine "generally works to prevent taxpayers from claiming the tax benefits of transactions that, although within the language of the tax code, are not the type of transactions the law intended to favor with the benefit." *Id*. at 512 (emphasis added). The Court noted, however, that because "the subsidiaries became viable, ongoing business enterprises within the family

of Sherwin-Williams companies, and not businesses in form only, to be 'put to death' after exercising the limited function of creating a tax benefit," the subsidiaries were properly considered separate for taxation purposes. *Id*. at 517.

In a detailed discussion of the sham transaction doctrine, the Court noted that it has been applied at times as a two-prong test analyzing both "economic substance other than the creation of a tax benefit" (the "'objective' economic substance test") and a "business purpose other than obtaining a tax benefit" (the "'subjective' business purpose test"), where the presence of either factor requires that the transaction in question be respected for tax purposes. *Id*. at 515 (citations omitted). However, the Court instead applied the doctrine as a single-prong test that treats "economic substance and business purpose as 'more precise factors to consider in the application of [the] traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses.'" *Id*. at 516, *quoting Sochin v. Comm'r of Internal Revenue*, 843 F.2d 351, 354 (9th Cir.), *cert. den'd*, 488 U.S. 824 (1988) (citations omitted). The Court's finding of economic substance and business purpose were in turn based in large part on the subsidiary's receipt of significant royalties from unrelated third parties, a factor that is not present in this case.

The same Court by the same author had reached a different conclusion, however, in *Syms Corp. v. Comm'r of Revenue*, 765 N.E.2d 758 (Mass. 2002). In *Syms*, the taxpayer similarly transferred its trademarks to a subsidiary, SYL. It then leased the marks back and paid royalties to the subsidiary, deducting the cost as a business expense. In *Sherwin-Williams*, the Court recounted it had found that the *Syms* transaction was "specifically designed as a tax avoidance scheme; royalties were paid to

the subsidiary once a year and quickly returned to the parent company as dividends; [SYL] did not do business other than to act as a conduit for the circular flow of royalty money; and the parent continued to pay all of the expenses of maintaining and defending the trademarks it had transferred." *Sherwin-Williams*, 778 N.E.2d at 513. Because the transfer and license back transaction had no practical economic effect on Syms other than the creation of tax benefits, and because tax avoidance was the clear motivation for the creation of the subsidiary, the deductions for royalty payments were properly disallowed. *Syms*, 765 N.E.2d at 764.

In *Talbots, supra,* the Massachusetts Appellate Tax Board reached the same result as the *Syms* court and affirmed the disallowance of the taxpayer's claimed royalty payment deductions. The critical factor in *Talbots* similarly was the complete absence of royalties paid by any third party, a factor also absent in this case.

**4. Analysis**

Based upon the relevant cases, we agree with the federal and Massachusetts approaches to this analysis. Consistent with prior Wisconsin cases, we analyze the "substance and realities"[5] of the transactions by focusing on economic substance, business purpose, and a showing that the transaction was not shaped solely by tax-avoidance features, an approach with which the Commission has long experience.

As noted above, Hormel had the burden of proving its case by clear and convincing evidence. While Hormel offered a significant amount of testimony on its own behalf at the hearing, including that of well-regarded experts, the documentary

[5] *See, generally, Manpower Inc. v. Dep't of Revenue,* Wis. Tax Rptr. (CCH) ¶ 401-223 (WTAC Aug. 12, 2009).

evidence created during the period surrounding the years at issue almost uniformly supports the Department's position. We find this contemporaneous documentary evidence to be the most persuasive evidence in the record.

Hormel argued at trial that the business purpose for forming Foods LLC was to protect and promote the intellectual property of Hormel. Hormel transferred its intellectual property to Foods LLC, licensed it back, paid royalties to Foods LLC, and deducted these as ordinary and necessary business expenses. These funds then wound their way back to Hormel through a series of additional transactions with other related entities.

In a memo to the Board of Directors at the formation of Foods LLC, Hormel stated six objectives for the new company:

> 1. Management tool to determine the value of the company's intellectual property,
> 2. Comparison with other entities to facilitate meaningful measure of performance,
> 3. Closer management of the use and protection of the intellectual property,
> 4. Focus on use and exploitation of the intellectual property,
> 5. Strengthening the relationship between product development and broad development, and
> 6. Reduction of the cost of doing business, including taxes.

However, the evidence overwhelmingly establishes that the primary purpose for the creation of Foods LLC and the royalty payments was tax avoidance. The idea for the restructuring originated with E&Y and Hormel's tax director as a plan to reduce Hormel's state income taxes. Hormel and E&Y entered into a consulting agreement that focused on minimizing Hormel's state tax liability. The new structure created a circular flow of funds among Hormel and its Affiliates, which included the

royalties that gave rise to the deductions disallowed by the Department. The claimed deductions flowing out of the new structure generated significant tax benefits for Hormel.

Reducing taxes is a perfectly legitimate business goal so long as it is not the primary purpose for a transaction. In this case, the evidence shows that Hormel's other alleged purposes for engaging in the challenged transactions were a mere "fig leaf" covering its real purpose, which was tax avoidance. (Dept. Brf. at 62.) Foods LLC did not manage the intellectual property transferred to it any differently than Hormel, and, in fact, Hormel largely retained control over all decisions related to that property while it was held by Foods LLC. Foods LLC granted exclusive licenses in all of its intellectual property to Hormel and its other Affiliates. Foods LLC never licensed this property to any unrelated third party and never had any income from a license to a third party. All of Foods LLC's income came from Hormel and its Affiliates. As in *Talbots*, *supra*, these facts strongly indicate that the challenged royalties had no economic substance or business purpose.

Hormel also argues that the transfer of its engineering and R&D divisions and operations to Foods LLC shows it had economic substance and a business purpose. However, the evidence shows that this transfer was accomplished primarily to give economic substance to Foods LLC in order to protect the tax planning behind its creation. Moreover, the evidence shows that the divisions and personnel transferred to Foods LLC did not alter their operations after the transfer, indicating that the restructuring was not undertaken for business purposes. Indeed, the change was so minimal that it is not clear that all of the personnel transferred to Foods LLC were even

aware of the restructuring. Finally, when Hormel elected to discontinue Foods LLC's operations in 2004, it simply did so without further explanation. If there had been a real business purpose behind the restructuring that created Foods LLC, then Hormel's officers and managers certainly should have been able to explain why Foods LLC was unsuccessful or did not meet the company's objectives, but they did not.

For Hormel to prevail, it had to prove that the transactions upon which the deductions were based were ordinary and necessary. In this case, that required showing the transactions had practical economic effects other than the creation of income tax losses, such as a business purpose and economic substance. We believe that the evidence at trial clearly established that the royalty transactions had no economic substance and served no business purpose other than tax avoidance.

**ORDER**

The Department's action on the Petitioner's petition for redetermination of the assessment at issue is affirmed.

Dated at Madison, Wisconsin, this 29th day of March, 2010.

**WISCONSIN TAX APPEALS COMMISSION**

________________________________________
David C. Swanson, Chairperson

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Roger W. Le Grand, Commissioner

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Thomas J. McAdams, Commissioner

ATTACHMENT: **"NOTICE OF APPEAL INFORMATION"**