

STATE OF WISCONSIN
TAX APPEALS COMMISSION

SKECHERS USA, INC.,
Petitioner,

DOCKET NOS. 10-I-171
AND 10-I-172¹

v.

WISCONSIN DEPARTMENT OF REVENUE,
Respondent.

DECISION AND ORDER

ELIZABETH KESSLER, COMMISSION CHAIR:

The Commission conducted a trial in these cases in Madison, Wisconsin, on May 9-12, 2022, Commissioner Elizabeth Kessler, presiding. The Petitioner was represented by Attorneys Michael J. Bowen and Aleksas A. Barauskas of Akerman LLP, Jacksonville, Florida. The Respondent, the Wisconsin Department of Revenue (“the Department”), was represented by Attorneys Mark S. Zimmer and Nicole M. Kuehl. Both parties filed post-trial briefs.

It should be noted that these matters were originally filed with the Tax Appeals Commission in 2010, along with a companion case, Skechers II, TAC Docket Number 10-I-173 (“SKII”). These cases were held in abeyance pending the final outcome in the companion case, and they were subsequently scheduled for trial in April 2020. Due

¹ The original version of this decision included uncorrected docket numbers.

to the COVID-19 pandemic, the Wisconsin Tax Appeals Commission held no trials in April 2020. The trial in these appeals was ultimately held May 9 - 12, 2022.

Based upon the proceedings at trial, the exhibits received at trial, the Joint Stipulation of Facts submitted prior to the trial, and the entire record, the Commission finds, concludes, and orders as follows:

FINDINGS OF FACT

JURISDICTIONAL FACTS

1. Skechers USA, Inc ("Skechers") is a corporation headquartered in Manhattan Beach, California. (Joint Stipulation of Facts ("Jt. Stip."), ¶ 6.)

2. Skechers sells "Skechers" brand footwear throughout the United States, including in Wisconsin, and in certain foreign countries. Skechers operates on a calendar year basis for tax reporting and accounting purposes. (Jt. Stip., ¶ 1.)

3. On June 15, 1999, Skechers formed Skechers USA Inc. II ("SKII"), a Delaware corporation, as a wholly-owned subsidiary. (Jt. Stip., ¶ 2.)

4. SKII is a Delaware corporation headquartered in Manhattan Beach, California. (Jt. Stip., ¶¶ 2, 6.)

5. On October 11, 2007, the Wisconsin Department of Revenue ("Department") issued a Notice of Field Audit Action to Skechers reflecting an assessment (the "2000 Assessment") for corporate franchise taxes for the 2000 tax year in the amount of \$996,637.51. (Jt. Stip., ¶ 32, Ex. 3 to Jt. Stip.)

6. On December 7, 2007, Skechers timely filed a Petition for Redetermination (“2000 Petition for Redetermination”) protesting the 2000 Assessment to the Department. (Jt. Stip., ¶34, Ex. 4 to Jt. Stip.)

7. On December 19, 2008, the Department issued a Notice of Field Audit Action to Skechers reflecting an assessment (the “2001-2003 Assessment”) for corporate franchise taxes for the 2001-2003 tax years in the amount of \$2,626,161.24. (Jt. Stip., ¶ 36, Ex. 6 to Jt. Stip.)

8. On February 16, 2009, Skechers timely filed a Petition for Redetermination (“2001-2003 Petition for Redetermination”) protesting the 2001-2003 Assessment to the Department. (Jt. Stip., ¶ 38, Ex. 7 to Jt. Stip.)

9. On April 23, 2010, the Department issued a Notice of Action (the “2000 Notice of Action”) that concluded the 2000 Petition for Redetermination should be affirmed in part and denied in part. The 2000 Assessment was reduced to \$415,115.69. (Jt. Stip., ¶ 35, Ex. 5 to Jt. Stip.)

10. On April 23, 2010, the Department issued a Notice of Action (the “2001-2003 Notice of Action”) that concluded the 2001-2003 Petition for Redetermination should be affirmed in part and denied in part. The 2001-2003 Assessment was reduced to \$701,576.75. (Jt. Stip., ¶ 39, Ex. 8 to Jt. Stip.)

11. Both of the Department’s Notices of Field Audit Action and both of the Department’s Notices of Action indicated the Department’s position that the intercompany transactions between Skechers and SKII were sham transactions or otherwise lacked a valid business purpose. (Jt. Stip., ¶¶ 33, 35, 37, and 39.)

12. On June 10, 2010, Skechers timely filed Petitions for Review with this Commission. Those Petitions for Review were the subject of the trial which addressed these cases. (Commission file.)

MATERIAL FACTS

BACKGROUND

13. Skechers was formed in 1992 and until 1999 was a closely-held subchapter S corporation for federal income tax purposes. (Trial Transcript (“Tr.”) pp. 49, 61, 71, 72; Ex. S, p. 6.)

14. The CEO and Chairman of the Board of Skechers was Mr. Robert Greenberg. (Jt. Stip. ¶ 31(l).) Mr. Greenberg's focus was and is building the Skechers brand – *i.e.*, the design, marketing, advertising, and branding functions of the company. (Tr. pp. 38-40.)

15. Mr. David Weinberg joined Skechers in 1992 at the time of the business' formation. (Tr. p. 72.) Since joining the company, Mr. Weinberg has been responsible for overseeing the operational functions of the company, which include the distribution, sales, finance, importation and legal functions. (Tr. p. 37.)

16. At the May 2022 hearing in these matters, the Department called on Mr. Jerome Gebert, a Tax Resolution Supervisor, who had been the Resolution Officer responsible for handling the petitions for redetermination filed by Skechers during the Audit Period, to testify as a factual witness. (Tr. pp. 566-568.)

17. At the May 2022 hearing in this matter, Skechers called on Mr. David Weinberg, COO of Skechers, who had been the CFO of Skechers during the Audit Period;

Mr. Brian Cross, VP of Corporate Tax of Skechers, who was initially hired by Skechers as Tax Manager in November 2001, during the Audit Period; and Mr. Steven Mandel, VP of Global Brand Licensing for SKII, who was initially hired by SKII in November 2010. (Tr. pp. 37, 216-218, 384-386.)

18. Before the formation of SKII, Skechers developed and purchased intellectual property, including trademarks, service marks, copyrights, patents, and additional pending patent applications. (The "Intellectual Property," Tr. pp. 160-161; Ex. 37, Bates Stamp number SUSA-000063; Exs. AE, AF, AG.)

19. On the formation of SKII, Skechers contributed all of its then-existing domestic intellectual property ("the Domestic IP"), which is intangible personal property, along with \$18,000,000.00 (eighteen million dollars) in cash to SKII, in exchange for 100% of the stock of SKII. (Jt. Stip., ¶ 3.)

20. SKII immediately conveyed the rights to the Domestic IP back to Skechers. (Ex. 37, Bates Stamp number SUSA-000174-SUSA-000180; Tr. pp. 160-163.) Under the licensing agreement for this conveyance, Skechers was required to pay all of its operating margin in excess of two percent (2%) to SKII as a royalty. (Ex. 37, Bates Stamp number SUSA-000269.)

21. For each year of the Audit Period, Skechers claimed a Wisconsin franchise tax deduction for the royalties paid to SKII. (Tr. pp. 608-623; Exs. 39-43.)

22. SKII remained a wholly-owned subsidiary of Skechers throughout the Audit Period. (Jt. Stip., ¶ 5.)

23. Skechers retained all rights to its international intellectual property (“the International IP”). (Jt. Stip., ¶ 4.)

24. The Department’s auditor, Mr. Art Foeste, asked for information explaining how the royalty payment, intercompany interest, management fees, and service agreements had been determined. (Ex. 45, Bates Stamp number DOR000014-DOR000015; Tr. pp. 587-88.) This information was not provided. (Id.)

25. In the 2000 Assessment, the Department denied the entire royalty expense paid by Skechers to SKII, denied the entire balance of interest paid on the net unpaid balance of royalty fees by Skechers to SKII, and adjusted the amount of the deduction taken by Skechers for management fees charged to and paid by SKII. The auditor identified the transfer and leaseback of the intangible assets as a sham transaction or otherwise lacking in a valid business purpose. (Jt. Stip., ¶ 33.)

26. In the 2001-2003 Assessment the Department denied the entire royalty expense paid by Skechers to SKII, denied the entire balance of interest paid on the net unpaid balance of royalty fees by Skechers to SKII, adjusted the amount of the deduction taken by Skechers for management fees charged to and paid by SKII, and denied the research and development expense deduction taken by Skechers in 2001. The Assessment indicated the Department’s opinion that the intercompany transactions between Skechers and SKII were sham transactions or otherwise lacked a valid business purpose. (Jt. Stip., ¶ 37.)

KPMG AND STATE TAX MINIMIZATION SERVICES

27. In 1998, the last full year before Skechers created SKII, almost 10% of all of Skechers gross wholesale sales were shipped to Wisconsin. This amounted to more than \$29 million. (Ex. 16, Bates Stamp number KPMG 1172-3; Tr. pp. 575-576.)

28. KPMG was Skechers audit firm, and it approached Skechers to purchase "State Tax Minimization" services. KPMG initially made its presentation for its State Tax Minimization services to Skechers in 1998, and developed a presentation titled "Skechers USA, Inc. State Tax Minimization." (Ex. 9; Ex. 11.)

29. In May 1999, KPMG made another presentation to Skechers, on the feasibility of the KPMG State Tax Minimization Step. KPMG proposed, among other strategies, that Skechers create a wholly owned subsidiary and transfer its Intellectual Property to that company for the purpose of licensing that IP. (Ex. 11, Bates Stamp numbers KPMG000647-KPMG000648.)

30. In that presentation, KPMG stated that the pre-restructuring effective state tax rate for Skechers was 7.69% and that post-restructuring the effective state tax rate would be 6.44%. (Ex. 11, Bates Stamp numbers KPMG000645-KPMG000646.)

31. KPMG employees were in contact by email with Skechers personnel including Skechers VP of Finance, Greg Christopoulos, and Skechers Senior VP of Finance, Mark Bravo, regarding the State Tax Minimization Project before Skechers entered into an agreement with KPMG to provide such services. (Ex. 17, Bates Stamp number KPMG001079; Tr. pp. 577-578.)

32. In June 1999, Skechers entered into an agreement with KPMG to perform services and develop strategies designed to result in a first full year tax benefit to Skechers of approximately \$1.1 million, and approximately \$8.5 million over the next five years. (Ex. 12, Bates Stamp number KPMG001012-KPMG001015.)

33. The State Tax Minimization strategies needed to be invisible to Skechers employees and customers, to the extent possible. (Ex. 63, pp. 50-51; Ex. 25, Bates Stamp number KPMG001097; Tr. p. 690.)

34. KPMG prepared a Design Report for the proposed implementation of the State Tax Minimization strategy, which was sent to senior executives for Skechers, including David Weinberg, Executive VP and CFO; Philip Paccione, Executive VP and General Counsel; Greg Christopoulos, VP of Finance; and Mark Bravo, Senior VP of Finance. Paccione was also the Secretary and a board member of Skechers; Weinberg was also a board member. (Ex. 30, Bates Stamp numbers KPMG000651-KPMG000652; Tr. pp. 120.)

35. Mr. Weinberg testified that he had no recollection of seeing either the 1998 or 1999 State Tax Minimization presentations from KPMG prior to his first deposition in these matters. (Tr. pp. 51, 53.)

36. The Design Report indicated that the Tax Minimization Strategy was designed to reduce the overall state income tax liability of Skechers and to generate state tax savings. This was to be accomplished by shifting large portions of the overall net income to SKII, which would give Skechers a lower net income in "separate entity" states

such as Wisconsin. (Ex. 30, pp. KPMG 663-664) After the Audit Period, in 2009, Wisconsin changed from a separate entity state to a “combined reporting” state. (Tr. pp. 569, 633.)

37. The Design Report indicated that Skechers would create SKII as a wholly owned subsidiary, and contribute the Domestic IP to the new entity. Skechers would then pay SKII a licensing fee for the use of that Domestic IP, including the name Skechers and associated trademarks. (Ex. 30, Bates Stamp numbers KPMG000662-KPMG000663.)

38. KPMG indicated in the Design Report that this restructuring would provide Skechers with a gross state income tax savings of \$740,000 in 1999, and between \$1-1.2 million annually between 2000-2002. (Ex. 30, Bates Stamp number KPMG000657.)

39. The Design Report also indicated that this tax savings would be achieved by shifting approximately 60% of the total operating profits from Skechers to SKII. (Ex. 30, Bates Stamp number KPMG000661.)

40. KPMG prepared a detailed implementation plan for the Skechers State Tax Minimization Project, including completion dates and specifically assigned responsibilities. (Ex. 12, Bates Stamp number KPMG001013; Ex. 37, Bates Stamp numbers SUSA-000310-SUSA-000314.) KPMG was to prepare a transfer pricing report to determine the royalty rate Skechers would pay SKII for the use of the Domestic IP. This report would also include the interest to be paid and management fees. (Ex. 37, Bates Stamp numbers SUSA-000065-SUSA000070.)

41. KPMG employee David Glugatch, who was responsible for the day to day management of the Skechers State Tax Minimization Project, does not recall doing

any non-tax-related cost benefit analysis for Skechers as part of this project. (Ex. 63, pp. 21, 30-31; Tr. p. 687.)

42. Neither Skechers nor KPMG provided the Department with any evidence that anyone conducted a cost benefit analysis of any business benefit, aside from state tax minimization, for creating SKII and transferring the ownership of the Domestic IP to the wholly owned subsidiary. (Tr. pp. 116, 126.)

43. KPMG utilized the comparative profits method in determining royalty rates. It determined that the arm's length royalty rate between Skechers and SKII, for rights to the Domestic IP, should be set at a rate that would leave Skechers with an operating margin of two percent (2%). (Ex. 37, Bates numbers SUSA-000065-SUSA-000070.)

44. Mr. Weinberg testified that he did not recall ever meeting with Mr. Glugatch. (Tr. p. 50.) However, in deposition, Mr. Guglatch specifically recalled meeting with Mr. Weinberg, describing Mr. Weinberg's office view with details confirmed by Mr. Weinberg at the hearing. (Ex. 63, pp. 21-22; Tr. pp. 150, 687-88.)

45. In June, 1999 (the precise date is unclear), Mr. Weinberg signed an engagement letter on behalf of Skechers, with KPMG, to assist Skechers with state tax planning services. (Ex. 12.)

46. Skechers did not engage its corporate law firm, or anyone else, to develop a corporate reorganization plan focused on any non-tax benefits. (Tr. pp. 84-85.)

47. On June 15, 1999, Skechers formed SKII. Mr. Weinberg stated that Skechers agreed to the restructuring because it documented the way the company was already operating and did not plan to change any of the operations. (Tr. pp. 115, 197-198.)

48. In connection with the formation of SKII, KPMG provided Skechers with proposed Board resolutions and sample intercompany agreements. (Exs. 23 and 24; Tr. 132.) The two intercompany agreements were the Licensing Agreement and the Management Services Agreement (the "MSA"). (Ex. 24.)

49. Mr. Weinberg considered the tax benefits of the State Tax Minimization Project to be sufficient without any non-tax cost benefit analysis. (Tr. p. 126.)

50. KPMG agreed not to bill Skechers for services until state tax savings were recognized. (Ex. 13, Bates Numbers KPMG001016-KPMG001017; Ex. 35, Bates Number KPMG001030; Tr. p. 148.) In January 2000, KPMG provided an invoice to Skechers in the amount of \$128,000, based on an estimated tax savings of \$270,000, for the purposes of state tax planning services. (Id.)

51. Mr. Cross testified that he knew Mr. Glugatch when Mr. Glugatch was with the state tax group at KPMG and would call him if he had state tax questions. (Tr. p. 342.)

THE INTERCOMPANY AGREEMENTS BETWEEN SKECHERS AND SKII

54. The License Agreement provided that SKII granted Skechers a non-exclusive license to use the Domestic IP in return for the quarterly payment of a royalty. (Ex. 1, Bates Numbers SUSA-000433, SUSA-000435.) The royalty calculation was

determined by KPMG. Skechers was required to pay a royalty to SKII at a rate that left Skechers with an operating margin of 2% of domestic sales each quarter. The Department did not challenge the pricing conclusions determined in the Report. (Ex. A, admitted at trial.) No changes were made to the License Agreement to reflect those changes. (Tr. p. 354.)

55. The License Agreement further provided that Skechers was to pay simple interest to SKII on the unpaid balance of the royalties due to SKII. (Ex. 1, Bates Number SUSA-0004351.) These royalty payments were solely based on journal entries. (Tr. pp. 90-93, 345.) All funds began and ended in the same Skechers bank account. (Tr. pp. 345, 605.) All interest calculated on unpaid royalties due to SKII from Skechers was a deduction for the purposes of Wisconsin state income taxes. (Tr. pp. 366-368.)

56. The only apparent transactions in the SKII bank account were the initial \$18 million dollar capital contribution and the sweep back into a Skechers bank account which immediately followed. At some point following the Audit Period, the account was closed because it was not being used. (Tr. p. 365.)

57. Mr. Cross testified that he did not strictly adhere to the 2% royalty fee. (Tr. 250-251.) Mr. Cross explained that federal law required periodic updating to the royalty amount to make sure it remained arms' length. (Tr. pp. 251-252.) From 1999 to 2005, the royalty amount varied from 1.7% of domestic sales to 3.0% of domestic sales. (Tr. p. 253.) No exhibits were introduced at trial explaining how the royalties were calculated. (Tr. p. 351.)

58. The Licensing Agreement provided a guaranteed 2% profit each year for Skechers while the risk relating to brand ownership remained with SKII. (Tr. p. 293.)

59. In 2005, Mr. Cross made the decision to no longer require payment of a royalty from Skechers to SKII. (Tr. pp. 261-262, 353.) Mr. Cross testified that he made this decision because states did not like it and he did not want to fight states from now to eternity over a royalty payment, so he stopped making royalty payments from Skechers to Skechers II. (Tr. p. 259.)

60. Mr. Weinberg testified that the reason Skechers stopped making royalty payments to SKII was that it had become onerous and contentious between some states and it just wasn't worth it any more. (Tr. p. 187.)

61. No changes were made to the Licensing Agreement reflecting the decision by Skechers to cease making royalty payments to SKII. (Tr. p. 354.)

62. The MSA provided that Skechers would provide certain "back office" services for SKII. (Jt. Stip., ¶ 9., Ex. I, Bates Stamp numbers KPMG000959-KPMG000960.) These services included operational functions like payroll, legal, human resources, finance, and tax. (Ex. I, Bates Stamp numbers KPMG000959-KPMG000960; Tr. pp. 165-167.)

63. The terms of the MSA state that Skechers is to provide these services at cost to SKII. (Ex. I, Bates Stamp numbers KPMG000959-KPMG000960, KPMG000962; Tr. p. 378.) However, until 2007 Skechers charged a 3.5% markup for its services provided to SKII. Mr. Cross testified that federal law prior to 2007 required a markup, but after 2007, federal law made clear that such services could be charged at cost. (Tr. p. 272.)

64. Skechers continues to provide SKII with the operational function services agreed to under the MSA. SKII pays Skechers an actual cost management fee for these services. (Tr. pp. 268-271.)

65. Mr. Cross explained that under the MSA, there are two types of costs allocated to SKII. Indirect costs - such as general services provided by human resources - are charged to SKII on an apportioned basis. Direct costs - such as legal fees relating to SKII's ownership of the Domestic IP - are not apportioned, but are charged directly to SKII at cost. (Tr. pp. 279-280.)

66. The Federal Trade Commission (FTC) sued Skechers for deceptive advertising in connection with alleged health benefits from its Shape Up shoes. Mr. Weinberg testified that he signed a consent decree agreeing to a \$40 million dollar fine in that matter in 2012. (Tr. p. 105.)

67. Mr. Weinberg testified that although he signed the consent decree with the FTC, he did not know what it contained. He also testified that he did not know whether the FTC sued Skechers or SKII, nor whether the \$40 million was paid by Skechers or SKII. (Ex. 78, Tr. pp. 105-108.)

68. Mr. Cross testified that although Skechers cut the check to pay the fine to the FTC, the cost was charged directly to SKII. He indicated that this was because SKII does all of the advertising, and the FTC suit related to advertising practices. (Tr. pp. 337-338.)

69. Mr. Steven Mandel, the Vice President of Global Brand Licensing for SKII, and the former Director of Global Brand Licensing, testified that he was hired in

November 2010 by SKII. When he was initially deposed in this dispute, Mr. Mandel was not aware that he was employed by SKII rather than by Skechers. He testified that he subsequently researched the matter and learned that he was initially hired and remained employed by SKII. (Tr. pp. 384-386.)

70. Mr. Mandel testified that his role is to find new licensees, negotiate deals, collect royalties, and enforce contracts for Skechers. (Tr. p. 386.)

71. Mr. Mandel testified that he is responsible for both foreign and domestic IP licensing. He indicated that typically domestic licensing agreements include rights to license for sale in Canada. Mr. Mandel further testified that he is not aware of what Skechers affiliated entity owns the domestic or the international rights to Skechers IP. (Tr. pp. 422-423.)

CASH MANAGEMENT SERVICES PROVIDED BY SKECHERS SKII

69. Skechers provided cash management services to SKII. It is common among large and midsize businesses for one entity of an affiliated group to act as the "bank" for its affiliates. Such structures create corporate efficiencies by preventing duplicative functional departments in the same affiliated group. (Tr. pp. 225-226.)

70. Mr. Cross testified that Skechers operates as a bank for SKII. (Tr. p. 312.)

71. The banking practices engaged in between Skechers and SKII were entirely a matter of internal recordkeeping or journal records, with the sole exception of the initial \$18 million capital investment on the creation of SKII. (Tr. pp. 90-93, 345.)

EXPERT WITNESS TESTIMONY

72. Skechers called Mr. Melvin Garner as an expert witness on intellectual property. Mr. Garner has had a long career both in the development of intellectual property as an electrical engineer, and subsequently as an intellectual property lawyer. (Tr. pp. 443-446.) Mr. Garner testified that in his expert opinion the creation of SKII had non-tax intellectual property benefits that were significant in terms of business results. (Tr. p. 447.)

73. Mr. Garner testified that individuals at the operating level within Skechers did not need to be aware of the non-tax benefits in creating SKII at the time of the creation, in order for there to be a valid business purpose in creating SKII. (Tr. p. 449.)

74. Mr. Garner testified that the formation of SKII helped protect the existing intellectual property. He indicated that it can be difficult in many corporate structures to identify and protect intellectual property because those responsible for creating the intellectual property need assistance from those outside their core group. By placing all of those responsible for creating and protecting intellectual property into SKII, Mr. Garner testified that it would theoretically be easier to identify and protect the intellectual property. This benefit was not realized by Skechers at the time SKII was formed because Mr. Greenberg, the CEO and chief decision maker for the company, assisted in identifying and protecting intellectual property. Mr. Garner explained that the benefit of the current structure will not be appreciated until Mr. Greenberg leaves his position as CEO. (Tr. pp. 450-452.)

75. The Department called Mr. Thomas Cotter as an expert witness on intellectual property. Mr. Cotter is a professor at the University of Minnesota Law School with areas of specialization including intellectual property law. Mr. Cotter testified that in his expert opinion he did not find any IP related reasons for the conveyance of Skechers IP to SKII and the subsequent license back from SKII to Skechers. (Tr. pp. 696, 702-703.)

76. Mr. Cotter's report indicated that he did not believe there was an IP related business purpose for forming SKII. (Ex. Q.) Mr. Cotter also testified to this opinion, noting the following points: The same people continued to do the same tasks. There was no evidence of problems with completing those tasks prior to 1999. There was no valuation of the IP conducted. And there was no increase in overall net income or earnings per share except for the reduction in state tax liability. (Tr. pp. 716-723.)

DISCUSSION

The Department auditor identified the deductions at issue as sham transactions and communicated this to Skechers in the Notices of Redetermination. The burden of demonstrating that these transactions had a valid business purpose other than tax avoidance and had economic substance was then transferred to the petitioner.

PRESUMPTION OF CORRECTNESS

Assessments by the Department are presumed to be correct, and the burden is upon the taxpayer to prove by clear, convincing, and satisfactory evidence in what respects the Department erred in its determinations. *Calaway v. Dep't. of Revenue*, Wis. Tax Rptr. (CCH) ¶ 400-856 (WTAC 2005), citing *Puissant v. Dep't. of Revenue*, Wis. Tax Rptr. (CCH) ¶ 202-401 (WTAC 1984).

Every piece of documentary evidence that was contemporaneously produced to justify the creation of SKII and the subsequent transactions at issue stressed the reduction of state tax liability. Although some documents also included other justifications, the fact that even those justifications were couched within KPMG's "State Tax Minimization" services emphasizes that any such other justifications were window dressing intended to obscure the fact that their purpose was tax avoidance.

There was also no documentary evidence showing that the royalty payments disallowed by the department had economic substance. No evidence was introduced indicating any change to business practices, profitability, or intellectual property took place after SKII was created, compared to prior to 1999.

CREDIBILITY OF PETITIONER'S EVIDENCE

In addition to documentary evidence, Skechers relied heavily on testimony from employees David Weinberg, Brian Cross, and Steven Mandel, along with expert witness Melvin Garner.

Mr. Weinberg was the CFO of Skechers at the time SKII was created. He has been with the company since 1992 and at the time of this proceeding was the COO. He testified that he had no memory of KPMG approaching Skechers with a proposal for State Tax Minimization services, nor of signing any such agreements. He testified that he did not recall ever discussing them with KPMG employees.

This claim, quite simply, lacks credibility. Other Skechers and KPMG employees recall these meetings. Mr. Weinberg recalled that he considered the tax benefit to be a sufficient business purpose to justify the creation of SKII. As the CFO, Mr.

Weinberg implemented a change to the corporate structure alleged to reduce the effective tax rate by approximately from 7.69% to 6.44% – a tax savings of approximately 16%. While in 2022 he might not recall the moment of signing a contract or the precise details of a process that began in 1999, given the amount of money at stake and the length of time this has been under appeal, a CFO would recall such business decisions in broad strokes, at least.

That the creation of SKII lacked economic substance was reinforced by the testimony of Mr. Steven Mandel, Vice President for Global Brand Licensing of SKII. Not only did Mr. Mandel only realize that he was employed by SKII and not Skechers after being called as a witness in this matter, but he also testified that he and his predecessors entered into agreements with third parties which did not accurately reflect the IP ownership rights of Skechers and/or SKII. SKII only legally owns the domestic IP rights. During the audit period, Skechers remained the owner of international IP rights; subsequently different wholly owned IP holding companies were created to license internationally. However, SKII is the signatory on a number of international IP licensing agreements, in spite of having no legal authority to enter into such agreements. If these ownership rights and the associated transactions had economic substance, either at the time of the Audit Period or at the time of the trial, the executives responsible for negotiating licensing agreements would have been aware of them.

Finally, Skechers expert witness, Mr. Melvin Garner, testified that it was possible for Skechers to have a valid business purpose other than tax avoidance and to have had economic substance in its royalty transactions with SKII, even if no one

employed by Skechers was aware of such a purpose. Mr. Garner used two analogies to explain this claim. First, he compared having only one Skechers corporate entity versus having both Skechers and SKII to having an old but functional car versus having both the old car and a high end sports car, indicating that running away from burglars would be easier in the high end sports car. Secondly, he compared the creation of SKII to his own financial planning wherein his wife wanted a trust to be the ownership entity of their family home, even though she did not understand why.

While the Commission agrees that not every employee of a company or set of corporate affiliates must understand the full structure of such affiliates to benefit from them, the fact that no employee of Skechers or SKII seemed to understand any benefit beyond tax minimization makes it difficult to believe that there are any benefits beyond tax minimization. Further, even those employees whose jobs were actually affected by the differences between Skechers and SKII were unaware of the distinction and ignored the legal differences, which surely undermines any such benefits.

THE SUBSTANCE OF PETITIONER'S CLAIMS

It is important to clarify the issues in this case. Petitioner submitted tax forms taking deductions for (1) Skechers claimed royalties and interest paid to Skechers II for the use of Domestic Intellectual Property during this period and (2) research and development expenses.² These deductions were based on a transfer of domestic rights to Skechers Intellectual Property from Skechers to SKII and the licensing back of those

² Petitioner's initial request for deductions for research and development expenses was, as noted by the Department, completely abandoned when it failed to present any evidence or testimony at the hearing related to that issue.

domestic rights to intellectual property to Skechers. The Department did not allow those deductions, on the basis that (1) Petitioner did not present a valid business purpose for the transactions other than tax avoidance; and (2) the transactions had no economic substance.³ The Department's decision to disallow the claimed tax deductions was based upon the transactions between Skechers and SKII – and not the creation of KSkechers I. However, the creation of Skechers II was reviewed at length in the pleadings and at the hearing, and the Commission finds the creation of Skechers II instructive as to the transactions subsequently flowing to and from it.

The Commission previously reviewed a similar fact scenario in *Hormel Foods Corp. v. Wisconsin Dept. of Revenue*, Wis. Tax Rptr. (CCH) ¶ 401-302 (WTAC March 29, 2010). The case focused on a corporation which established a wholly-owned subsidiary primarily as a way to generate state tax savings. Following a field audit of the years at issue, the Department disallowed Hormel's claimed royalty deductions and issued its 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

³ Petitioner incorrectly framed the Department's position, stating "The Department's position is that Skechers was not entitled to the claimed tax deductions because the *decision* to form SKII in 1999 lacked a valid business purpose and was without economic substance." [emphasis added] Petitioner's Post-Trial Brief, page 1. The Department's decision was based upon the *transactions* between Skechers and Skechers II.

necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses.

The Commission's decision noted applicable Wisconsin statutes and regulations did not provide additional relevant guidance in interpreting § 71.30(2), Stats., and Wisconsin courts had 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). The decision then reviewed cases from Wisconsin courts and the Commission which addressed similar issues, and various federal cases and cases from other jurisdictions which the Commission also found instructive. After completing that review, the Commission stated:

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. [emphasis added]. (*Hormel*, p. 42.)

In this case, the parties agree that the decision in *Hormel* is applicable and provides a valid test for the Commission to use in deciding whether to object to or respect transactions between related entities under Wis. Stat. Stat. § 71.30(2). Therefore, Petitioner must prove the transactions had both (1) a business purpose and (2) economic substance. However, Petitioner asserts the Department is not appropriately applying the finding in *Hormel* and presents its argument as follows:

In *Hormel*, under similar facts, the Commission ruled against the taxpayer and sustained the denial of tax deductions. The focus of *Hormel* was the significance of acts occurring *outside* the relevant audit period.

The taxpayer argued that the Commission was limited to the facts existing *during* the audit period. The Department countered that events *outside* the audit period were relevant to the dispute. The Commission agreed with the Department, reviewed events outside the audit period, and affirmed the assessment. The Department's position in this dispute is patently *contradictory* to that taken in *Hormel*.⁴ . . . In this case, Skechers is simply asking the Commission to and once again consider facts and circumstances outside the Audit Period to evaluate whether the formation of SKII was supported by a valid business purpose and economic substance. A thorough review of the relevant facts reflects that SKII was a "viable business" engaged in "substantive business activity" at the moment it was formed. The undisputed facts with respect to events occurring *outside* the Audit Period make clear that SKII has continued to grow its business separate and apart from that of Skechers. For these reasons, the Assessments must be abated. [emphasis in original] (Petitioner Post-Trial Brief, p. 2.)

The Commission does not agree with this argument nor find it persuasive. The Department's Pre-Trial Brief lists 49 separate fact comparisons between the taxpayer in *Hormel* and Skechers.⁵ Those comparisons present alleged facts before, during and after the audit period. And documents and testimony admitted during the trial presented evidence for time periods before, during and after the audit period. The parties agree with many of the facts in this case. Where they differ is in how those facts are reviewed and applied to determine whether Petitioner had a valid business purpose for the transactions other than tax avoidance and whether those transactions had any economic substance.⁶

⁴ Counsel to the Department in this case also represented the Department during the *Hormel* dispute.

⁵ Respondent's Pre-Trial Brief, page numbers not provided.

⁶ Petitioner incorrectly framed the Department's position, stating "The Department's position is that Skechers was not entitled to the claimed tax deductions because the *decision* to form SKII in 1999 lacked a valid business purpose and was without economic substance." [emphasis added] Petitioner Post-Trial Brief, page 1. The Department's decision was based upon the *transactions* between Skechers and Skechers II.

WAS THERE A VALID BUSINESS PURPOSE FOR CREATING SKII?

Ironically, Petitioner's assertion that "[a] thorough review of the relevant facts reflects that SKII was a "viable business" engaged in "substantive business activity" at the moment it was formed" is part of the reasoning for the Commission's determination there was no valid business purpose other than tax avoidance in the creation of KII. Even Petitioner's Chief Operating Officer (who was Chief Financial Officer of the company during the audit period), Mr. Weinberg, acknowledged the formation of SKII merely documented the way the company was currently operating - and would continue to operate. (Tr. pp. 115, 198; Petitioner's Post-Trial Brief, p. 8.) Petitioner spent a great deal of time documenting how, essentially, nothing changed before and after the creation of Skechers II and the transactions under review in this case.

This begs the question - if nothing changed in Petitioner's operations, aside from continuing to grow its markets, expand its brand and increase its sales - why create SKII? Tellingly, the reasons presented by Petitioner through its evidence and testimony were all generated after SKII was created. The reasons presented by Skechers before the creation of SKII all addressed tax savings - and only tax savings: KPMG's presentations to Skechers solely focused on avoiding state taxes; the Design Report for the State Tax Project focused on state tax avoidance and the Restructuring Implementation Report created at the end of the State Tax Minimization Project focused on the state tax benefits and stated the purpose was to reduce Skechers' state tax liability.

In addition, prior and up to the creation of SKII, Petitioner did not identify any reason, other than tax avoidance, that required the creation of SKII. Documents and testimony highlight no (a) business problem or need identified or (b) benefit to be obtained (other than tax avoidance) before the creation of SKII or the transactions at issue. Petitioner's expert witness Melvin Garner opined as to several valid, non-tax, intellectual property-related benefits relation to the formation of SKII (Exhibit P), but tellingly none of these reasons were considered by Petitioner *before* the formation of SKII. (Petitioner's Post-Hearing Brief, p. 13.)

WAS THERE A VALID BUSINESS PURPOSE IN THE TRANSFER OF DOMESTIC INTELLECTUAL PROPERTY TO SKII AND THE LICENSING OF THE IP BACK TO SKECHERS?

Pursuant to the *Hormel* decision, the Department viewed the transaction (the transfer of the domestic rights to Skecher's Intellectual Property, and the license back), as a "sham transaction" asserting it was primarily done for tax savings. The Department again references KPMG's communications with Petitioner and documents supplied to Petitioner and asserts that nothing actually changed in the operations of Skechers or in the management of its Intellectual Property, indicating that there was no nontax business purpose to the transactions transferring the intellectual property to SKII and licensing it back to Skechers. Specifically, the Department points to Petitioner's claimed business purposes which were partly garnered from the forms suggesting business purposes supplied by KPMG and in part after-the-fact rationalizations of theoretical business benefits, not genuine nontax business purposes that were actually held by Skechers at the time.

Petitioner again focused on the business purpose of the creation of SKII. Specifically, petitioner asserted the formation of SKII helped to protect the existing intellectual property. Petitioner's expert witness Melvin Garner stated his expert opinion that there were several valid, non-tax, intellectual property-related benefits related to the formation of SKII. (Ex. P.) Petitioner further asserted as follows:

The formation of SKII helped protect the existing intellectual property. It can be difficult in many corporate structures to identify and protect intellectual property because those responsible for creating the intellectual property need assistance from those outside their core group. By placing all of those responsible for creating and protecting intellectual property into SKII, it made it easier to identify and protect the intellectual property. *This benefit was not realized by Skechers at the time SKII was formed because Mr. Greenberg, the CEO and chief decisionmaker for the company, assisted in identifying and protecting intellectual property.* Mr. Garner explained that the benefit of the current structure will not be appreciated until Mr. Greenberg leaves his position as CEO. (Tr. 450-452.) [emphasis added] (Petitioner Post Trial Brief, pp. 13-14.)

The above supports the assertion there was no valid business purpose for the transaction at the time. Therefore, Petitioner failed to prove by clear and satisfactory evidence that it subjectively had nontax business reasons for the transfer of the Intellectual Property to SKII and the license back to Skechers.

DID THE TRANSFER OF DOMESTIC INTELLECTUAL PROPERTY TO SKII AND THE LICENSING OF THE IP BACK TO SKECHERS HAVE ECONOMIC SUBSTANCE?

Again, the Department asserts the transactions under review were primarily for tax savings and did not serve any identified business purpose. The Department's primary argument is that the licensing transactions created no meaningful economic change pretax and claimed \$495 million of deductions for moving money from

one of Petitioner's entities to another, without the potential for profit or risk of loss. And that these transactions were all undertaken pursuant to the directives in State Tax Minimization Project.

Petitioner again asserts the creation of SKII was a viable business entity that had economic substance. Petitioner points to the fact that as the business continued to grow, the number of SKII employees increased from 128 in 2003 to 303 and 2019, that its 3rd party licensing revenue grew proportionally with its employee count, that it incurred substantial expenses to generate that licensing revenue and that due to the exponential growth of its business all SKII employees needed to move to new a larger office space. Petitioner spends a great amount of time and effort to explain the growth experience by SKII. However, again the Commission notes that this viable business entity was already in existence prior to the paperwork. And, Petitioner continues to miss the focus of this appeal, which is whether the transfer of domestic intellectual property to SKII and the licensing of it back to Skechers had economic substance.

CONCLUSION

The burden of proof is on Petitioner to prove that the Department's assessment is incorrect by clear and satisfactory evidence. In this case, Petitioner must prove that it had a valid nontax business purpose for entering into the licensing transaction that generated the royalty deductions claimed on its Wisconsin tax returns and that the licensing transaction had economic substance. Both are required. Petitioner

did not present persuasive evidence or testimony of either requirement being met. Therefore, the Department's assessments are upheld.

CONCLUSIONS OF LAW

1. Petitioner did not have a valid nontax business purpose for the creation of SKII.
2. Petitioner did not have a valid nontax business purpose for entering into the licensing transactions between Skechers and SKII that generated the royalty deductions claimed on its Wisconsin tax returns.
3. Petitioner's licensing transactions between Skechers and SKII did not have economic substance.

ORDER

Based upon the foregoing,

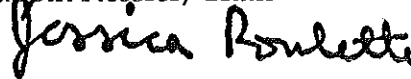
IT IS HEREBY ORDERED that the Department's assessment is affirmed and this appeal is dismissed.

Dated at Madison, Wisconsin, this 24th day of February, 2023.

WISCONSIN TAX APPEALS COMMISSION



Elizabeth Kessler, Chair



Jessica Roulette, Commissioner



Kenneth Adler, Commissioner

ATTACHMENT: NOTICE OF APPEAL INFORMATION

WISCONSIN TAX APPEALS COMMISSION
101 E Wilson St, 5th Floor
Madison, Wisconsin 53703

NOTICE OF APPEAL INFORMATION

NOTICE OF RIGHTS FOR REHEARING, OR JUDICIAL REVIEW, THE TIMES ALLOWED FOR EACH, AND THE IDENTIFICATION OF THE PARTY TO BE NAMED AS RESPONDENT

A taxpayer has two options after receiving a Commission final decision:

Option 1: PETITION FOR REHEARING BEFORE THE COMMISSION

The taxpayer has a right to petition for a rehearing of a final decision within 20 days of the service of this decision, as provided in Wis. Stat. § 227.49. The 20-day period commences the day after personal service on the taxpayer or on the date the Commission issued its original decision to the taxpayer. The petition for rehearing should be filed with the Tax Appeals Commission and served upon the other party (which usually is the Department of Revenue). The Petition for Rehearing can be served either in-person, by USPS, or by courier; however, the filing must arrive at the Commission within the 20-day timeframe of the order to be accepted. Alternately, the taxpayer can appeal this decision directly to circuit court through the filing of a petition for judicial review. It is not necessary to petition for a rehearing first.

AND/OR

Option 2: PETITION FOR JUDICIAL REVIEW

Wis. Stat. § 227.53 provides for judicial review of a final decision. Several points about starting a case:

1. The petition must be filed in the appropriate county circuit court and served upon the Tax Appeal Commission and the other party (which usually is the Department of Revenue) either in-person, by certified mail, or by courier, within 30 days of this decision if there has been no petition for rehearing or, within 30 days of service of the order that decides a timely petition for rehearing.
2. If a party files a late petition for rehearing, the 30-day period for judicial review starts on the date the Commission issued its original decision to the taxpayer.
3. The 30-day period starts the day after personal service, or the day we mail the decision.
4. The petition for judicial review should name the other party (which is usually the Department of Revenue) as the Respondent, but not the Commission, which is not a party.

For more information about the other requirements for commencing an appeal to the circuit court, you may wish to contact the clerk of the appropriate circuit court or, the Wisconsin Statutes. The website for the courts is <https://wicourts.gov>.

This notice is part of the decision and incorporated therein.