STATE OF WISCONSIN

TAX APPEALS COMMISSION

SKECHERS USA, INC. II **DOCKET NO. 10-I-173**

Petitioners,

vs.

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

RULING AND ORDER

DAVID D. WILMOTH, COMMISSIONER:

This case comes before the Commission for decision on Cross-Motions for Summary Judgment. The Petitioner, Skechers USA, Inc. II ("SKII" or the "Petitioner"), is represented by Attorneys Michael J. Bowen and Peter O. Larsen, both of the law firm of Akerman LLP, Jacksonville, FL. The Respondent, the Wisconsin Department of Revenue ("the Department"), is represented by Attorney Mark S. Zimmer. The parties have filed briefs with exhibits and affidavits in support of their respective motions, as well as a joint Stipulation of Facts.

There are several issues presented in this case, all of which ultimately come down to whether the Department has the statutory and/or constitutional authority to impose Wisconsin income or franchise tax on SKII. For the reasons stated

below, we determine they do not have statutory authority and, consequently, we grant summary judgment to the Petitioner.

FACTS

Jurisdictional Facts

1. On December 19, 2008, the Department issued a Notice of Field Audit Action to SKII reflecting an assessment (the "Assessment") for corporate franchise taxes due in the amount of $2,402,929.80. The Assessment was issued "in the alternative" to two separate corporate franchise tax assessments issued to Skechers USA, Inc. ("Skechers"), for calendar years 2000 through 2003 (the "Period"), the Commission's Docket nos. 10-I-171 and 10-I-172, which the parties have agreed may be held in abeyance pending a determination in this docket. (Stipulation of Facts ("Stip.") ¶ 41; Ex. 3.)

2. The Assessment asserted that SKII had corporate franchise tax nexus with Wisconsin under Wis. Admin. Code § Tax 2.82(4)(a)9 based on the fact that SKII licensed certain intellectual property to Skechers for use in Wisconsin. (Stip. ¶ 42.)

3. On February 16, 2009, SKII timely filed a Petition for Redetermination protesting the Assessment to the Department. (Stip. ¶ 43; Ex. 4.)

4. On April 23, 2010, the Department issued a Notice of Action that denied SKII's Petition for Redetermination, affirmed the Assessment, and restated its position that SKII had corporate franchise tax nexus with Wisconsin under Wis. Admin. Code § Tax 2.82(4)(a)9 based on the fact that SKII licensed intellectual property to Skechers for use in Wisconsin. (Stip. ¶ 44; Ex. 5.)

5. The redetermination on April 23, 2010, by the Department's Resolution Unit, also confirmed that the corporate franchise tax assessment issued against SKII was an assessment in the alternative pursuant to § 71.74(9), Wis. Stats. (Stip. ¶ 45.)

6. SKII filed a timely Petition for Review with this Commission, dated June 22, 2010, appealing the Department's denial of its Petition for Redetermination. (Commission file.)

7. At a telephone scheduling conference with the Commission, held on April 1, 2014, the parties informed the Commission that they were in agreement that this case turned on issues of law which could be resolved on cross-motions for summary judgment. The Commission then issued a briefing order, and the parties filed briefs with exhibits and affidavits in support of their respective motions, as well as a joint stipulation of facts. (Commission file.)

Material Facts

8. Skechers sells "Skechers" brand footwear in the United States through department stores, specialty stores, athletic retailers, boutique retail stores, and through its own retail outlets across the United States and certain foreign countries. (Stip. ¶ 1.)

9. Skechers formed SKII on June 15, 1999, as a wholly-owned subsidiary of Skechers. (Stip. ¶ 2.)

10. On formation, Skechers contributed all then-existing domestic intellectual property, including trademarks, patents, and copyrights (the "Domestic IP"),

which is intangible personal property, and $18,000,000.00 in cash, to SKII in return for 100% of the stock of SKII. (Stip. ¶¶ 3, 7; Ex.1.)

11. SKII remained a wholly-owned subsidiary of Skechers during the Period. (Stip. ¶ 5.)

12. Skechers and SKII are headquartered in Manhattan Beach, California. (Stip. ¶ 6.)

13. During the Period, SKII owned all domestic rights to license the Domestic IP associated with "Skechers" brand footwear. (Stip. ¶ 7; Ex. 1.)

14. SKII licensed the Domestic IP to Skechers and to unaffiliated third parties for use throughout the United States, including Wisconsin. (Stip. ¶¶ 7, 13, 17)

15. Skechers and SKII entered into a licensing agreement (the "Licensing Agreement") in 1999 relating to the use of the Domestic IP in the United States during the Period. (Affidavit of SKII Chief Executive Officer Robert Greenberg ("Greenberg Aff.") ¶ I.)

16. Skechers and SKII negotiated and executed the Agreement outside the State of Wisconsin. (Greenberg Aff. ¶ J.)

17. During the Period, Skechers, and not SKII, controlled how and where the Domestic IP was to be used consistent with the terms of the License Agreement. (Greenberg Aff. ¶ L.)

18. In addition to licensing the Domestic IP, SKII was also responsible for designing, developing, and marketing "Skechers" brand footwear. (Stip. ¶ 8.)

19. Any and all business activity relating to the designing, developing, and marketing of "Skechers" brand footwear during the Period took place outside of Wisconsin. (Greenberg Aff. ¶ M.)

20. Since its formation, SKII has developed design patents and has worked to increase the number of patents and trademarks for use domestically (including in Wisconsin) by Skechers and its affiliates. (Stip. ¶ 9.)

21. Any and all business activity related to SKII's efforts to develop design patents and increase the number of patents and trademarks for use domestically by Skechers and its affiliates took place outside of Wisconsin. (Greenberg Aff. ¶ S.)

22. Prior to the formation of SKII, Skechers engaged KPMG to prepare a transfer pricing report (the "Report"). The Report determined the royalty rate SKII would charge Skechers for the use of the Domestic IP. (Stip. ¶ 10.)

23. Consistent with the Report, SKII charged Skechers, and Skechers paid SKII, a royalty fee associated with Skechers' use of the Domestic IP throughout the United States, including in Wisconsin. (Stip. ¶ 11, 12.)

24. SKII also received royalties from unaffiliated third parties for use of the Domestic IP in Wisconsin and elsewhere. (Stip. ¶ 14.)

25. SKII had no offices, employees, or representatives in Wisconsin. (Stip. ¶ 15.)

26. SKII owned no real or tangible personal property in Wisconsin. (Stip. ¶ 16.)

27. SKII did not file Wisconsin corporate franchise tax returns with the Department. (Stip. ¶ 18.)

28. Skechers made wholesale sales of shoes during the Period to Famous Footwear and certain other Wisconsin-based customers. (Stip. ¶ 38.)

29. All of the shoes sold by Skechers to Famous Footwear and other Wisconsin-based customers during the Period bore and incorporated the Domestic IP licensed by SKII to Skechers. (Stip. ¶ 39.)

30. During each of the years of the Period, Skechers shipped into Wisconsin footwear bearing and incorporating the Domestic IP licensed from SKII. (Stip. ¶ 40; Ex. 2.)

ISSUES PRESENTED

1. Whether, during the Period, the Department had the statutory authority to impose Wisconsin franchise tax on SKII pursuant to Wis. Stat. § 71.23(2).

2. If not, whether, during the Period, the Department had the statutory authority to impose Wisconsin income tax on SKII pursuant to Wis. Stat. § 71.23(1).

3. Whether, under Wis. Stat. § 71.25(9)(d), all "income-producing activities" relating to SKII's licensing of intangible property during the Period occurred outside Wisconsin during the Period, thereby resulting in the apportionment of none of SKII's income to the state.

4. Whether the Department wrongly excluded the property and payroll factors from the otherwise applicable three-factor statutory apportionment formula outlined in Wis. Stat. § 71.25(6) in apportioning SKII's income for the Period.

5. Whether the imposition of Wisconsin income or franchise tax on SKII during the Period violates either or both of

the Due Process and the Commerce Clauses of the United States Constitution.

RELEVANT STATUTES AND ADMINISTRATIVE RULES

Wis. Stat. § 71.25(5) (2001-02)
Corporations engaged in business both within and without the state.
(a) Apportionable income. Except as provided in sub. (6), corporations engaged in business both within and without this state are subject to apportionment. Income gain or loss from the sources listed in this paragraph is presumed apportionable as unitary or operational income or other income that has a taxable presence in this state. Apportionable income includes all income or loss of corporations, other than nonapportionable income as specified in par. (b), including, but not limited to, income, gain or loss from the following sources:

...

6. Royalties from intangible assets.

Wis. Stat. § 71.25(6) (2001-02)
Allocation and Separate Accounting and Apportionment Formula.
Corporations engaged in business within and without the state shall be taxed only on such income as is derived from business transacted and property located within the state. The amount of such income attributable to Wisconsin may be determined by an allocation and separate accounting thereof, when the business of such corporation within the state is not an integral part of a unitary business, but the department of revenue may permit an allocation and separate accounting in any case in which it is satisfied that the use of such method will properly reflect the income taxable by this state. In all cases in which allocation and separate accounting is not permissible, the determination shall be made in the following manner: for all businesses except financial organizations, public utilities, railroads, sleeping car companies, car line companies and corporations or associations that are subject to a tax on unrelated business income under s. 71.26 (1) (a) there shall first be deducted from the total net income of the taxpayer the part thereof (less related expenses, if any) that follows the situs of the

property or the residence of the recipient. The remaining net income shall be apportioned to Wisconsin by use of an apportionment fraction composed of a sales factor under sub. (9) representing 50% of the fraction, a property factor under sub. (7) representing 25% of the fraction and a payroll factor under sub. (8) representing 25% of the fraction.

Wis. Stat. § 71.25(9)(d) (2001-02)
Sales, other than sales of tangible personal property, are in this state if the income-producing activity is performed in this state. If the income-producing activity is performed both in and outside this state the sales shall be divided between those states having jurisdiction to tax such business in proportion to the direct costs of performance incurred in each such state in rendering this service.

Wis. Stat. § 71.25(9)(e) (2001-02)
In this subsection, "sales" includes, but is not limited to, the following items related to the production of business income:

...

10. Gross royalties from income-producing activities.

Wis. Admin. Code Tax § 2.39(6) (2000-2003)
For purposes of this paragraph, "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. This activity does not include activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, the income producing activity includes ... [t]he rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

ANALYSIS

1. Summary Judgment

Both parties have moved for summary judgment. A motion for summary judgment will be granted if the pleadings, depositions, answers to interrogatories, and

admissions on file, together with the affidavits, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. Wis. Stat. § 802.08(2).

When simultaneous motions for summary judgment are pending, the parties in effect stipulate to the underlying material facts because they are both claiming that only issues of law are before the Commission. *See Eichenseer v. Madison-Dane County Tavern League, Inc.*, 2008 WI ¶ 4, 308 Wis. 2d 683, 748 N.W.2d 154. We agree that the relevant facts in this case are not in dispute and this matter is ripe for summary judgment.

2. Background

In 1999, Skechers formed SKII as a wholly-owned subsidiary, transferring the Domestic IP - all of Skechers' valuable domestic intellectual property - and some cash to SKII in exchange for all of its stock. Then, pursuant to a license arrangement, Skechers paid royalties to SKII in exchange for Skechers' use of the Domestic IP, at rates established by a pricing study prepared by Skechers' accounting firm.

This structure was commonly used by multi-state businesses during the 1980s, 1990s, and into the 2000s. The affiliate to which the intellectual property used by the operating company is transferred has variously been referred to as a "passive investment company," an "intellectual property holding company," or an "IP affiliate," among other labels. For convenience's sake, we will refer to them generically as IP affiliates.

The principal tax effect of the structure was to reduce the taxable income

of the operating company in so-called separate reporting states. Separate reporting states, as opposed to combined reporting states, tax each business entity separately on its own income. By contrast, combined reporting states tax the combined income of affiliated business entities which are together engaged in a unitary business.

In a typical situation, a multistate operating company transferred valuable intellectual property used in its business to an affiliate which was organized and located in a low- or no-tax state, or in a combined reporting state in which the operating company was already paying tax. The operating company then paid the IP affiliate a royalty for its use of the intellectual property, at rates calculated to be "arm's-length," and deducted those payments from its taxable income.

In separate reporting states, this structure served to reduce the taxable income of the operating company by the amount of the deduction taken for the royalties paid. The IP affiliate receiving the payments would not file or pay tax in the separate reporting state, claiming it has no presence in, and thus no tax nexus with, the state. The structure did not have the same tax-reduction effect in combined reporting states, inasmuch as the operating company and the IP affiliate were affiliated companies operating a unitary business, all of the income of which was reported in the combined reporting state.

During the Period, Wisconsin was a separate reporting state.

Participating in a national trend,[1] Wisconsin later adopted combined reporting for tax years beginning on or after January 1, 2009.[2] This trend was attributable in part to taxpayers' use of certain structures, including IP affiliates, to reduce taxes in separate reporting states.[3]

State tax authorities in separate reporting states, including the Wisconsin Department of Revenue, challenged the use of IP affiliates. Initially, these challenges came by means of denying the operating company a deduction for the royalty payments made to the IP affiliate on any number of grounds. The denials were typically based on claims that the primary purpose for the formation of the IP affiliate and the transfer of intangible assets was tax avoidance and it otherwise lacked a valid business purpose, the IP affiliate lacked economic substance, the organization of the IP affiliate was a sham transaction, and/or denial of the deduction for the royalty payments was necessary to more clearly reflect income pursuant to the state's version of IRC § 482. The Department's denial of the deductions claimed by Skechers for royalty payments made to SKII during the Period is the basis of the assessments against Skechers in the Commission Dockets being held in abeyance pending the outcome of

[1] See, e.g., Joe Huddleston and Shirley Sicilian, History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute? The State and Local Tax Lawyer, 2008 Symposium Edition 3 (2008); William F. Fox and LeAnn Luna, Combined Reporting With the Corporate Income Tax: Issues for State Legislatures, Report Commissioned by the NCSL Task Force on State & Local Taxation of Communications and Interstate Commerce (2010).
[2] 2009 Wisconsin Act 2
[3] See, e.g., *Combined Reporting of Corporate Income Taxes: An Option for South Carolina?*, Institute on Taxation and Economic Policy, Policy Brief #5 (2007).

this case.[4]

Beginning in the 1980s, the Commission saw scores of appeals filed by operating companies whose deductions for royalty payments to IP affiliates were denied by the Department. The vast majority of these appeals were settled or withdrawn. None went to trial until *Hormel Foods Corp. v. Dep't of Revenue,* Wis. Tax Rptr. (CCH) ¶ 401-302 (WTAC 2010). In that case, Hormel Foods transferred valuable intellectual property, along with its engineering and research and development operations, to a newly-formed affiliate and then deducted royalty payments it made to the affiliate for use of the intellectual property. In upholding the Department's denial of deductions, the Commission concluded that the evidence at trial overwhelmingly established that the primary purpose for the creation of the affiliate and the payment of royalties was tax avoidance, and that payment of the royalties otherwise had no economic substance or business purpose. No other case involving royalty payments to an IP affiliate has gone to trial in Wisconsin since *Hormel.*

Sometime in the 1990s, the Department began to make "alternative assessments" against IP affiliates seeking to tax their royalty income in the alternative to assessments against the operating companies denying their royalty deductions. The Commission saw appeals filed for many of these alternative assessments. But until now, these alternative assessments have been resolved short of being presented to the Commission for a decision.

[4] The parties acknowledged in their briefs that if SKII prevails in this case, the Department will proceed against Skechers in the dockets held in abeyance.

The operating companies in these matters, like Skechers here, usually had property, employees, and activities in Wisconsin. The IP affiliates, like SKII here, typically had no physical presence in the state. That lack of physical presence raises legal issues not present in the cases involving the operating companies.

Over thirty years ago, in *Complete Auto Transit v. Brady,* 430 U.S. 274 (1977), the United States Supreme Court laid out a four-part test to evaluate whether a state tax imposed upon a multistate business would survive a challenge under the Due Process and/or Commerce Clauses of the U.S. Constitution: (1) whether the activity taxed has a substantial nexus with the taxing state; (2) whether the tax is fairly apportioned to the taxing jurisdiction; (3) whether the tax discriminates against interstate commerce; and (4) whether the tax is fairly related to the services the state provides the taxpayer. *Id.* at 279. Large portions of the parties' briefs are, understandably, devoted to the first part of the *Complete Auto Transit* test - whether businesses with no physical presence in Wisconsin and whose activities consist exclusively or primarily of licensing intangible property to others who sell products in the state, have nexus with the state for income or franchise tax purposes. Secondarily, the parties address issues under the second and fourth parts of the test. These are complex and largely unsettled issues which the Commission will likely be called upon to address at some point. But because we conclude that the statutes applicable during the Period do not serve to impose any Wisconsin income or franchise tax on SKII, we do not reach the Due Process and Commerce Clause issues.

The remaining questions are statutory ones: (1) whether, during the

Period, the Department had the statutory authority to impose on SKII Wisconsin income or franchise tax pursuant to Wis. Stats. §§ 71.23(1) or (2); (2) if so, whether, under Wis. Stat. § 71.25(9)(d), all "income-producing activities" relating to SKII's licensing of intangible property occurred outside Wisconsin, thereby resulting in the apportionment of none of SKII's income to the state; and (3) if some of the income-producing activity did occur in Wisconsin such that the sales factor was greater than zero, whether the Department wrongly excluded the property and payroll factors, both of which were zero, from the Wisconsin apportionment formula. Because we conclude that, even if SKII were subject to income or franchise tax during the Period, none of its income would be apportioned to Wisconsin under the sales factor, we do not address the issues of statutory authority under Wis. Stats. § 71.23 or whether the property and payroll factors were properly excluded.[5]

3. Apportionment of Multistate Income

In order to survive a Commerce Clause challenge, Wisconsin franchise tax imposed on multistate business income must be fairly apportioned. *Complete Auto Transit* at 279; *United Parcel Service Co. v. Dep't of Revenue*, 204 Wis. 2d 63, 72, 553 N.W.2d 861 (1996). States are given great leeway in arriving at apportionment formulas to tax

[5] During the Period, as noted below, Wis. Stat. § 71.25(6) provided for a three-factor apportionment formula consisting of property, payroll, and sales factors. However, Wis. Stat. § 71.25(11) allowed the Department to omit a factor if it "gives an unreasonable or inequitable final average ratio because of the fact that such corporation does not employ, to any appreciable extent in its trade or business in producing the income taxed, the factors made use of in obtaining such ratio." The Department claims that property and payroll were not meaningfully employed in producing SKII's Wisconsin income and therefore omitted them. The Petitioner disagrees. Because we find that the sales factor of SKII during the Period was zero, including or omitting the property and payroll factors does not have an effect on the final apportionment percentage.

business income. *United Parcel Service* 204 Wis. 2d at 73.

Wisconsin's corporate income apportionment provisions during the Period were based largely on The Uniform Division of Income for Tax Purposes Act ("UDITPA"). UDITPA is a model act drafted by the National Conference of Commissioners on Uniform State Laws. The organization adopted the act in 1957 and the American Bar Association approved it shortly thereafter.[6] The act was designed to set uniform rules and procedures for the allocation and apportionment of multistate corporate income.

In 1971 (effective for tax years beginning on or after January 1, 1973), Wisconsin adopted, for the most part, the UDITPA provision for apportioning multistate income using a three-factor apportionment formula consisting of property, payroll, and sales factors.[7] Wisconsin Statute § 71.25(6) provided, during the Period, "Corporations engaged in business within and without the state shall be taxed only on such income as is derived from business transacted and property located within the state." The statute goes on to state that multistate business income shall be "apportioned to Wisconsin by use of an apportionment fraction composed of a sales factor ... representing 50% of the fraction, a property factor ... representing 25% of the fraction and a payroll factor ... representing 25% of the fraction." This represents the UDITPA three-factor formula, but with the sales factor double-weighted. In general, each factor is itself a fraction, the numerator of which is the property, payroll, or sales of

[6] Arthur D. Lynn, *The Uniform Division of Income for Tax Purposes Act*, 19 Ohio St. L.J. 41 (1958).
[7] Chap. 125, Laws of 1971.

the taxpayer in Wisconsin, and the denominator of which is the property, payroll, or sales of the taxpayer everywhere. Wis. Stats. §§ 71.25(7)(a), (8)(a), and (9)(a).

The composition of the sales factor is described in Wis. Stat. § 71.25(9). Under Wis. Stat. § 71.25(9)(b), sales of tangible personal property are Wisconsin sales and included in the numerator of the sales factor if the "property is delivered or shipped to a purchaser ... within this state ...." Wisconsin Statute § 71.25(9)(d) addressed sales *other* than sales of tangible personal property (which included, for our purposes, the licensing of intangible property) and provided in pertinent part:

> (d) Sales, other than sales of tangible personal property, are in this state if the income-producing activity is performed in this state. If the income-producing activity is performed both in and outside this state the sales shall be divided between those states having jurisdiction to tax such business in proportion to the direct costs of performance incurred in each such state in rendering this service.

This particular provision was modelled after language contained in the UDITPA provisions adopted by Wisconsin in 1971, and, other than a renumbering, remained unchanged from the time of its adoption through the end of the Period.

The Department promulgated an administrative rule which addressed the concept of "income-producing activity" under Wis. Stat. § 71.25(9)(d). During the Period, Wis. Admin. Code Tax § 2.39(6) provided:

> For purposes of this paragraph, "income-producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. This activity does not include activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, the income producing activity includes ... [t]he rendering of personal services by

> employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

These, then, are the provisions that taxpayers, the Department, the Commission, and courts must apply in apportioning income generated by the licensing or use of intangible property. Because they were crafted in the 1950s, the application of these rules to a 21st century economy can pose significant challenges.

Noted state and local tax authority Professor Richard Pomp, commented on the challenges faced by separate reporting states when confronting well-planned structures designed to take advantage of the limitations in decades' old apportionment provisions:

> The corporate ... taxes labor under enough weaknesses without being the target of this formidable firepower. These taxes are built on a rickety foundation, constructed during the first half of this century to deal with what, by today's standards, seems to be the rather mundane taxation of manufacturing and mercantile activities. ... Multinational corporations and conglomerates were yet to emerge, and few corporations had substantial amounts of foreign income. It was a world in which corporations did not electronically transfer funds around the globe and did not make much use of financial derivatives. Large mail-order houses had not yet proliferated, 800 telephone numbers were not widespread, UPS and Federal Express were in their infancy, and the Internet did not exist. ...
>
> Today's challenges to the Wisconsin tax structure from the expanding, aggressive, and sophisticated private sector pose a fundamentally different type of problem. The antiquated structure of the tax makes it difficult to repel attacks by tax lawyers and accountants who are using modern weapons.

Richard D. Pomp, *State Tax Reform: Proposals for Wisconsin*, 88 Marq. L. Rev. 45 (2004) at 47-48.

Pomp's advice to Wisconsin was to adopt combined reporting which, as previously noted, Wisconsin did in 2009.

Likewise, the Multistate Tax Commission, which now administers UDITPA, has embarked on an effort to revise and update the act's provisions in light of the difficulties in applying them to modern transactions:

> But all legislation, even model legislation, seems to have a natural life-cycle which causes it to deteriorate, through legislative action or inaction, with each passing session. In the case of UDITPA, states are increasingly moving away from two of its provisions in particular - equal weighting of the three factors, and sales factor sourcing for services and sales of intangible property. In addition, a handful of specific provisions have proven to be unclear. The lack of clarity has made those provisions targets for change or clarification by state regulation, legislation, litigation, and sometimes all three.

Proceedings of the New York University Institute on State and Local Taxation, *The Project to Revise UDITPA*, Matthew Bender & Company (2009).

By the time these comments were made, Wisconsin had already addressed the two specific issues identified by the MTC. With respect to the three-factor apportionment formula, Wisconsin had enacted legislation to phase in a sales-only formula, which became fully implemented in 2007.[8] Wisconsin had also completely revamped the rules for determining the sales factor for services,[9] and sales of intangible property.[10]

4. Statutory Changes for the Sourcing of Income From Intangible Property for Purposes of the Wisconsin Sales Factor

[8] 2003 Wis. Act 37.
[9] 2005 Wis. Act 25.
[10] 2009 Wis. Act 2.

In 2005, the Legislature considered a proposed bill (2005 AB 100) implementing changes to the sales factor of the Wisconsin apportionment formula. The Wisconsin Legislative Fiscal Bureau (the "LFB")[11] prepared a whitepaper for the Legislature's Joint Committee on Finance explaining the proposed changes (the "LFB Paper").[12] The LFB Paper stated: "The bill's provisions would modify, by varying levels of significance, the sourcing rules for sales, other than sales of tangible personal property, for the purposes of the sales factor of the apportionment formula used under the state individual and corporate income and franchise tax."[13] The LFB noted:

> The method of sourcing sales for the sales factor of the apportionment formula assigns gross receipts from the sale of tangible personal property on a destination basis. By comparison, receipts from intangibles, computer software and services are assigned to the state where the income-producing activity occurs, measured by the cost of performance. In practice, income-producing activity is origin-based, so that receipts are usually assigned to the headquarters or domicile of the business. This is inconsistent with the destination—based treatment of sales of tangible personal property, and can create compliance and administrative problems in distinguishing between tangible products and intangible products or services. ... In addition, the current treatment of receipts for services and intangibles counteracts the intent of the single sales apportionment formula for in-state businesses that provide services or lease, license or provide computer software and intangible property. In general, receipts from such activities would be assigned to the state in which such

[11] The Wisconsin Legislative Fiscal Bureau is a nonpartisan service agency of the Wisconsin Legislature. The Bureau provides fiscal and program information and analyses to the Wisconsin Legislature, its committees, and individual legislators. The Bureau also serves as staff to the Joint Committee on Finance, a 16-member Committee which reviews and deliberates on legislation affecting state revenues and appropriations.
[12] Legislative Fiscal Bureau, Joint Committee on Finance, Paper #321, *Corporate Income and Franchise Tax – Treatment of Certain Sales in Sales Factor of Apportionment Formula* (May 25, 2005).
[13] LFB Paper ¶ 8.

> businesses have most of their employees and payroll. In these cases, firms located in Wisconsin would not benefit from single sales factor apportionment. Under the Governor's proposal, these businesses would have their taxes reduced.

LFB Paper ¶ 19.

The LFB Paper went on to state that "income-producing activity" can be difficult to identify and can cause problems for taxpayers. The LFB concluded that using a destination-based sourcing rule would be viewed as an improvement in the method of assigning sales receipts to states because it is easier to identify where the property or services is used or located.[14]

The LFB Paper identified addressing IP affiliate structures as one of the purposes for the proposed changes and provided an example of such a structure, the facts of which are quite similar to the IP affiliate structure presented in this case.[15] With respect to the example, the LFB concluded that, under the proposed law change, the IP affiliate would determine the amount of income sourced to Wisconsin based on the amount of royalties received for the use of the intangible property and that, as a result, "some businesses would pay more income and franchise taxes, and some businesses would have their have their income and franchise taxes reduced ...."[16]

As noted, 2005 AB 100 proposed specific changes to the sales factor provisions for each of services, software, and intangible property. Attachment 2 to the

[14] LFB Paper ¶ 20.
[15] LFB Paper Chart 1. Unlike SKII, the IP affiliate in the LFB example acknowledged some physical presence, and therefore franchise tax nexus, in Wisconsin. Consequently, this brought the apportionment issues to the forefront of the LFB analysis.
[16] LFB Paper ¶¶ 24, 25.

LFB Paper is a chart prepared by the Department outlining the current treatment for sourcing income for sales factor purposes as contrasted to the proposed treatment under 2005 AB 100. Under the proposed treatment for royalties for the use of intangible property, instead of using "income-producing activity," the royalty income would be sourced based on the ratio of the use of the intangible property in Wisconsin to the total use in all states. Ultimately, in 2005, the Wisconsin legislature adopted the change proposed in 2005 AB 100 to the sales factor sourcing rules for services and software, but not for the license and use of intangible property.[17]

In 2009, however, Wis. Stat. § 71.25(9)(dj) was enacted and made effective for taxable years beginning on or after January 1, 2009. It states, in pertinent part:

> (dj) Except as provided in (df) [related to software] gross royalties and other gross receipts received for the use or license of intangible property, including patents, copyrights, trademarks, trade names, service names, franchises, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, technical know-how, contracts, and customer lists, are sales in this state if any of the following applies:
>
> > 1. The purchaser or licensee uses the intangible property in the operation of a trade or business at a location in this state. If the purchaser or licensee uses the intangible property in the operation of a trade or business in more than one state, the gross royalties and other gross receipts from the use of the intangible property shall be divided between those states having jurisdiction to impose an income tax on the taxpayer in proportion to the use of the intangible property in those states. ...

[17] 2005 Wis. Act 25.

Thus, for 2009 and thereafter, royalties from the license of intangible property are sourced to where the licensee uses the property rather than to where the licensor's income-producing activities occur.

5. Application of Statutory Rules for the Sourcing of Income From Intangible Property to Royalty Income of SKII

The undisputed facts presented in this case show that, during the Period, SKII licensed the Domestic IP, consisting of valuable patents, trademarks, and copyrights, to Skechers and to unrelated licensees. SKII had no offices, employees, or representatives in Wisconsin. SKII owned no real or tangible personal property in the state. The Licensing Agreement between Skechers and SKII was negotiated and executed outside of Wisconsin. All activity engaged in by SKII relating to the designing, developing, and marketing of "Skechers" brand footwear, and all work to increase the number of patents and trademarks related to "Skechers" brand footwear, took place outside the state. Consistent with the terns if the License Agreement, Skechers, and not SKII, controlled how and where the Domestic IP was to be used.

In light of these facts, the Petitioner argues that it engaged in no income-producing activities in Wisconsin during the Period and, consequently, that none of its royalty income is properly included in the numerator of the Wisconsin sales factor. In contrast, the Department asserts that, because SKII's royalty income was generated by the sale of Skecher's shoes in Wisconsin and elsewhere, the relevant income-producing activity is the sale of shoes. As a result, the Department argues that the royalties from the sale of Skecher's shoes in Wisconsin should rightly be included in the numerator of

the sales factor and royalties from the sale of Skecher's shoes everywhere should be included in the denominator. We agree with the Petitioner.

During the Period, Wis. Stat. § 71.25(9)(d) provided that "Sales, other than sales of tangible personal property, are in this state if the income-producing activity is performed in this state." The Department's own long-standing rule at the time stated that "income-producing activity" means "the act or acts *directly engaged in by the taxpayer* for the ultimate purpose of obtaining gains or profit." Wis. Admin. Code Tax § 2.39(6) (emphasis supplied). The activity directly engaged in by SKII during the Period was the licensing of the Domestic IP. SKII did not sell shoes - Skechers did. The purchasers of Skecher's shoes are customers of Skechers, not SKII. The sale of shoes by Skechers in Wisconsin and elsewhere during the Period, while providing the measure of the royalties payable to SKII, is simply not an activity directly engaged in by SKII. To the extent the design, development, and marketing activities of SKII may have aided in Skechers' sales, those activities took place outside the state. Consequently, we conclude that SKII engaged in no income-producing activities in Wisconsin during the Period and that its Wisconsin sales factor is therefore zero.

While sourcing royalty income for sales factor purposes based on the location of the licensee's sales may be perfectly reasonable, it was simply not the statutory sourcing rule in effect during the Period. In fact, it *is* the sourcing rule ultimately adopted by the Wisconsin legislature for tax periods beginning on or after January 1, 2009. In urging the Commission to source the royalty income of SKII based

upon the sales of shoes by Skechers and its unrelated licensees,[18] the Department is asking us to conclude that the statutory change in 2009 resulted in no material change in the way income from intangible property is sourced for sales factor purposes.

"[T]here is a presumption that the legislature intends to change the law by creating a new right or withdrawing an existing right when it amends a statute." *In re Marriage of Lang v. Lang*, 161 Wis. 2d 210, 220, 467 N.W.2d 772 (1991). Not only do the rules of statutory construction presume a change in the law, it is evident from the statutory history reflected in the LFB Paper that both the Wisconsin legislature and the Department intended a substantive change in the rules for sourcing income from intangible property in calculating the Wisconsin sales factor. Specifically, it is clear that one of the intended results of the change was to fix perceived shortcomings in the prior rule's treatment of fact patterns just like the one presented in this case.

We understand that, when confronted with related party transactions that have the effect of reducing taxes, tax authorities and courts tend to approach them with a degree of skepticism. And certainly, if the facts were here to support it, the Department could attack this structure as having tax avoidance as its principal purpose, as it did in the *Hormel* case. But the Department has not done so in this case, instead reserving those arguments, and any supporting evidence, for the cases against Skechers

[18] The Department notes in its brief that, although there were royalties received by SKII from unrelated third parties, the Department's auditor had insufficient information regarding those royalties, and no assessment or adjustment was made for those royalties. As a result, the Department concludes that the amount of income attributable to Wisconsin is understated. We take that as an acknowledgment that there is no basis for applying the statute differently to unrelated licensees than to related licensees, and the parties have not argued that there is such a basis.

being held in abeyance pending the outcome of this case.[19]

In support of its position, the Department cites to *Ameritech Publishing, Inc. v. Dep't of Revenue*.[20] API was a Delaware corporation which sold local and national advertising placed in telephone directories distributed in Wisconsin during the years 1994 through 1996. These directories were commonly known at the time as the White Pages and the Yellow Pages. Local advertising was solicited by API sales representatives out of offices in Indiana, Michigan, Ohio, and Wisconsin, while sales representatives from the national sales offices in Michigan and Illinois solicited advertising nationally. API had production support centers in Michigan and Ohio. Directories containing the listings and advertisements were distributed free of charge to Wisconsin residents and businesses in the directory coverage area.

API claimed that the income these advertising services were generated by "income-producing activities" performed both within and without Wisconsin, thereby justifying them to use the "cost of performance" approach to sourcing the income for purposes of the numerator of the sales factor. The Department disagreed, contending that the income-producing activity API's customers contracted for was getting their listing and advertisements in front of a Wisconsin audience. Consequently, the income-

[19] In footnote 51 of its brief, the Department stated: "The legitimacy of this licensing transaction, whether the royalty was at fair market value, and whether the entire arrangement was a sham or was lacking in business purpose or economic substance, which would disallow Skechers' claimed deductions for the royalties paid to Skechers II, are matters not before the Commission here. That question need only be considered in determination of the companion cases, Docket Nos. 10-I-171 and 172, if the assessment against Skechers II is not upheld, since these are assessments in the alternative pursuant to sec. 71.74(9)."
[20] *Ameritech Publishing, Inc. v. Dep't of Revenue*, Wis. Tax Rptr. (CCH) ¶ 401-075 (WTAC 2008); aff'd Wis. Tax Rptr. (CCH) ¶ 401-337 (Dane Co. Cir. Ct. 2009), and Wis. Tax Rptr. (CCH) ¶ 401-326 (Ct. App. 2010) (unpublished decision).

producing activity was the distribution of the directories to Wisconsin residents, not the ancillary activities performed in other states.

In addressing the issue, the Commission turned to its prior decision in *The Hearst Corporation v. Dep't of Revenue*, Wis. Tax Rptr. (CCH) ¶203-149 (WTAC 1990), the facts of which were very similar to those presented to it in *Ameritech*. In that case, the petitioner operated the WISN television station in Milwaukee. One of several issues before the Commission was whether the revenue Hearst received from the sale of network and national advertising time on WISN was properly includable in the numerator of the sales factor of its Wisconsin apportionment formula. Like API, WISN generated advertising revenue in Wisconsin from both local advertising, solicited by a sales staff in Milwaukee, and national advertising, placed by national sales representatives located out of state. National advertising commercials were all produced independently of WISN and were transmitted to WISN by satellite feed or by courier. WISN incurred costs to broadcast these commercials and paid national sales commissions for the commercials. The Commission found that "the network and national advertising revenues are based upon the showing or broadcasting thereof. Without broadcasting there is no income." Noting that "advertisers choose spots based upon the demographic profile of the audience viewing the particular programming," the Commission concluded "the income producing activity is the actual broadcasting of the programming desired by the advertiser and the commercial spots during that programming and, thus, is in Wisconsin." *Id.*

For purposes of its *Ameritech* decision, the Commission determined that

Hearst was on point: "The service in question, advertising, was provided when the desired audience received the directories, and virtually all members of that audience were located in Wisconsin. Thus, the service, or income-producing activity, was performed in Wisconsin." The Wisconsin Circuit Court and Court of Appeals both affirmed the Commission's decision, with the Circuit Court stating:

> The majority opinion in *Hearst* teaches that "income producing activity" is determined by asking what service is being bought and sold. The terms of the contract are the best evidence of the revenue producing activity. In this case, the API contract clearly entitles the advertisers to get their white and yellow pages advertisement before the targeted audience in Wisconsin. It does not give the advertiser any legal right to, or impose any charge for, any of the other services that API claims as income-producing services: soliciting, creating, developing and producing design work for businesses.

Ameritech, Wis. Tax Rptr. (CCH) ¶ 401-337 (Dane Co. Cir. Ct. 2010).

The Department argues that the decision in *Ameritech* supports its view that the royalty income received by SKII from the licensing of the Domestic IP to Skechers and third parties was generated entirely by income-producing activities in Wisconsin. Specifically, the Department asserts: "Here, the connection to Wisconsin as the source of the income-producing activity is even clearer. The royalty income was generated directly from Skechers' sales to Wisconsin customers on Skechers brand shoes shipped to Wisconsin. That is the income-producing activity."

While the sale of Skechers shoes is certainly an income-producing activity, it is an activity of Skechers, not SKII. In both *Hearst* and *Ameritech*, the petitioners had employees, property, and direct activities in Wisconsin. They may have performed

ancillary activities outside of the state, but the Commission determined it was the broadcasting (in the case of *Hearst*) and the distribution of the directories (in the case of *Ameritech*) which were the services the advertisers had contracted and paid for. Those were in fact activities conducted by the petitioners in Wisconsin. By contrast, SKII had no employees or property in Wisconsin and did not directly engage in any activities in the state. As a result, it had no "income-producing activities" in Wisconsin, and no part of its royalty income is includable in the numerator of its Wisconsin sales factor.

In its reply brief, the Department states that sourcing the royalty income of SKII based upon Skecher's sale of shoes "is consistent with the market-based approach used by the Commission and the Court of Appeals in *Ameritech.*" We disagree. *Ameritech*, like *Hearst* before it, simply held that the service the customers contracted and paid for was the delivery of their ads to Wisconsin businesses and residents. To read *Ameritech* more broadly so as to impose a true market-based sales sourcing rule like the one adopted by the Wisconsin legislature in 2009, would be contrary to the express language of Wis. Stat. § 71.25(9)(d) and Wis. Admin. Code Tax § 2.39(6), as well as the legislative history leading up to the 2009 statutory change.[21]

[21] The Department itself argued against a too-broad reading of the Commission's *Ameritech* decision in its response to API's Petition for Review to the Wisconsin Supreme Court in the case: "Taxpayer ... attempts to transform an unpublished decision of the court of appeals concerning a statute that was replaced nearly six years ago into a case of national importance. The Commission's construction of the terminology in the statute and the subsidiary rule involves and is relevant only to the location where the income-producing activity of granting advertisers access to a local audience occurs."

CONCLUSIONS OF LAW

1. Petitioner's income-producing activity during the Period consisted of the licensing of the Domestic IP to Skechers and unrelated third parties, and related activities, and not the sale of shoes.

2. Under the law in effect during the Period, Wis. Stat. § 71.25(5) (2001-02), the Petitioner's income-producing activity occurred completely outside the State of Wisconsin and, thus, the Petitioner's Wisconsin sales factor under Wis. Stat. § 71.25(9)(d) was zero.

3. Because the Petitioner had no income properly apportionable to this state, the Assessment is reversed.

ORDER

Based on the foregoing, the Commission orders as follows:

1. The Petitioner's Motion for Summary Judgment is granted.
2. The Department's Motion for Summary Judgment is denied.
3. The Department's assessment is reversed.
4. This ruling and order is final and appealable.

Dated at Madison, Wisconsin, this 31st day of July, 2015.

WISCONSIN TAX APPEALS COMMISSION

Lorna Hemp Boll, Chair

David D. Wilmoth, Commissioner

ATTACHMENT: **NOTICE OF APPEAL INFORMATION**

WISCONSIN TAX APPEALS COMMISSION
5005 University Avenue - Suite 110
Madison, Wisconsin - 53705

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. Alternatively, 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. <u>Several points about starting a case</u>:

1. **The petition must be filed in the appropriate county circuit court and served upon the Tax Appeals Commission and the other party (which usually is the Department of Revenue) either in-person, by <u>certified</u> 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 *http://wicourts.gov*.

This notice is part of the decision and incorporated therein.