STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
THE SHERWIN-WILLIAMS COMPANY	:	DECISION DTA NO. 816712
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1987, 1989, 1990 and 1991.	: :	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on June 7, 2001 with respect to the petition of The Sherwin-Williams Company, 101 Prospect Avenue, N.W., Cleveland, Ohio 44115-1027. Petitioner appeared by Morrison & Foerster, LLP (Craig B. Fields and Paul Frankel, Esqs., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (James P. Connolly, James Della Porta and Brian J. McCann, Esqs., of counsel).

The Division of Taxation filed a brief in support of its exception, petitioner filed a brief in opposition and the Division of Taxation filed a reply brief. Oral argument, at the Division of Taxation's request, was heard on September 25, 2002. Subsequently, the Massachusetts Supreme Judicial Court issued its decision in ***The Sherwin-Williams Company v. Commissioner*** (438 Mass 71, 778 NE2d 504). The Division of Taxation filed a letter brief to address the Massachusetts case. Petitioner filed its reply to the Division of Taxation's letter brief on December 11, 2002.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether the Division of Taxation may require petitioner to file its franchise tax report on a combined basis with SWIMC, Inc. and DIMC, Inc., two of its subsidiaries.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "11," "15," "24," "29," "50," "104," "120," "126," "137," "138," "149," "150," "180," "187" through "200" and "331" through "390" which have been deleted as either unsupported by the record or irrelevant. We have modified findings of fact "14," "26," "28," "48," "98," "103," "118," "129," "209," "215," "227," "241," "245," "313" and "314." We have also made additional findings of fact. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional findings of fact are set forth below.

Petitioner, The Sherwin-Williams Company ("Sherwin-Williams" or "S-W"), filed a petition protesting a Notice of Deficiency of corporation franchise tax issued by the Division of Taxation ("Division").

1. As a result of a corporation franchise tax field audit, the Division, on January 13, 1997, issued a Notice of Deficiency (Notice No. L-013066163-1) to petitioner asserting additional corporation franchise tax due in the amount of $196,536.00, plus interest, for a total amount due of $296,682.72 for the years 1987 through 1991, except for 1988.

2. On August 31, 1998, a petition was filed challenging the assertion of additional corporation franchise tax. The petition asserts that the Division erred in requiring petitioner to

file a combined corporation franchise tax report with two of its affiliates, SWIMC, Inc. ("SWIMC") and DIMC, Inc. ("DIMC") for the year 1991. It also asserts that the Division erred in including certain royalty income received by petitioner in the computation of its entire net income base for the years 1989 through 1991. The issue concerning the royalty income is no longer in dispute.

Corporate History

3. Petitioner, incorporated under the laws of Ohio in 1884, has its principal place of business and commercial domicile in Cleveland, Ohio. It is engaged in the manufacture, distribution and sale of coatings, e.g., paints and related products, and is one of the largest manufacturers of paints and varnishes. Petitioner sells architectural coatings, industrial finishes and associated supplies through company-operated paint and wall covering stores under the label "Sherwin-Williams." It manufactures and sells coatings under other brands including, but not limited to, "Dutch Boy," "Martin-Senour," "Dupli-Color" and "Krylon," plus private label brands to independent dealers, mass merchandisers and home improvement centers. Sherwin-Williams also produces coatings for original equipment manufacturers ("OEM") in a number of industries and special purpose coatings for the automotive aftermarket, industrial maintenance and traffic paint markets.

4. Although Sherwin-Williams has developed many products over the years, it also has a long history of acquiring product lines and paint facilities. Sherwin-Williams' acquisitions, among others, include: the 1917 acquisition of the Martin-Senour Company of Chicago, a well-known maker of premium paints; the 1920 acquisition of Acme Quality Paints, Inc. of Detroit, a multi-million dollar business specializing in coatings for the carriage and automobile industries;

the 1966 acquisition of Sprayon Products of Ohio, a well-established aerosol packager specializing in spray paint; the 1980 acquisition of the "Dutch Boy" brand and paint facilities; the 1984 acquisition of Dupli-Color Products Company, specializing in automotive aftermarket paints and the 1990 acquisitions of Borden, Inc.'s "Krylon" and "Illinois Bronze" aerosol paint operations and De Soto, Inc.'s architectural coatings business.[1]

5. In addition to acquisitions, over time Sherwin-Williams expanded its own operations by either building or modernizing manufacturing plants as necessary. Although acquisitions and capital expansion helped fuel Sherwin-Williams' successful growth in the coatings industry, it also created a debt-ladened company which, in 1977, reported a loss and was unable to pay a dividend for the first time in its history.

6. In January 1979, with bankruptcy looming, John G. Breen was hired to turn Sherwin-Williams around. Upon becoming Sherwin-Williams' President and Chief Executive Officer, Mr. Breen hired a new management team consisting of Conway G. Ivy, who became Vice President of Corporate Planning and Development, and Thomas A. Commes, who became Senior Vice President of Finance.

Although none of these individuals had any knowledge about the paint business, they brought strong management skills to Sherwin-Williams. Mr. Breen and his new management team immediately began changing the Sherwin-Williams corporate culture. They held monthly meetings with all top executives to review operations. Managers were required to submit detailed written plans that explained the nature of their businesses, including products, strengths, weaknesses, competitors and future plans. Every division began to submit annual operating

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[1] De Soto, Inc., which traced its roots back to 1910 as one of the largest paint manufacturers in the United States, supplied private label paints to chains such as Sears and Home Depot.

plans from which Sherwin-Williams developed comprehensive policies that included budgeting, strategic planning and management assessment. Top executives and division managers actively participated in strategic planning and budgeting meetings. Mr. Breen made it clear that he did not expect to run Sherwin-Williams from the top down. Rather, the authority to set goals and the responsibility to meet them was delegated to people lower in the Sherwin-Williams hierarchy. Division managers were held directly accountable for their performance. Decentralization proceeded further by converting Sherwin-Williams' nine domestic divisions into profit centers, and by installing a rigorous management accounting system that charged the divisions for the use of working capital and fixed assets.

7. On the same day that Mr. Breen became president of Sherwin-Williams, Gulf and Western notified the Securities and Exchange Commission that it planned to purchase 25% of Sherwin-Williams stock. The threat of a hostile takeover by Gulf and Western was on the minds of the new management team as they began the task of turning Sherwin-Williams around. The success of the new management and cash management practices initiated under Mr. Breen's leadership was immediate. Sherwin-Williams was able to repurchase the shares held by Gulf and Western in late 1979.

8. Petitioner has always used trademarks, trade names and service marks (collectively "Marks") in conducting its business. The Marks included the "Sherwin-Williams" brand, registered on April 20, 1948, various "Cover the Earth" logos, the first one registered in 1906, several "Dutch Boy" trademarks, the first one registered on March 5, 1918, "Protecting the American Dream" a common law trademark and "The Look that Gets the Look" slogan, that was filed on March 2, 1990, to name just a few.

9. Under Sherwin-Williams' decentralized operating autonomy, the management of Sherwin-Williams' trademarks was handled at the divisional level. Although decentralization of Sherwin-Williams was good for its operations, decentralization of the authority to control and use the trademarks among its divisions caused management of the Marks to be diffused and caused conflicts among the divisions. Often the divisions did not place sufficient focus upon the Marks. Some Marks were used by more than one division. At times the operating divisions forgot that the Marks that they were using were not theirs alone, and those divisions would make changes in the presentation of the Marks as suited their purposes without clearance from Sherwin-Williams' legal department. Changes in the presentation of a trademark can lead to dilution of that trademark. If dilution of a trademark occurs, the owner of the trademark can lose its rights to the trademark. In one instance, the Chemical Coatings Division merged two marks, that merger could have potentially given rise to the dilution of both Marks. Also, the operating divisions did not always alert Sherwin-Williams' legal department about new trademarks they were using, causing a delay in federal registrations. Sometimes, without notifying the legal department, divisions discontinued using trademarks that might have been useful to other divisions of the company. Trademarks are deemed abandoned when they are not used and there is an intent to abandon their use.

10. In 1983, while in the process of structuring a joint venture with C-I-L Inc., a Canadian company, Mr. Ivy selected "Canada Paint," a trademark from a partial list provided by Sherwin-Williams' legal department as the name for the joint venture. He was informed that the name "Canada Paint Company" could not be used. At that time, it was discovered that the "Canada Paint" mark had not been used in Canada for over 20 years, unbeknownst to all at Sherwin-

Williams except the division in Canada that had been previously using it. During the 20-year hiatus of non-use another entity began to use the "Canada Paint" name, and Sherwin-Williams' rights in the trademark had been lost. Although Mr. Ivy did voice his concerns about how Sherwin-Williams' trademarks were being managed and the need for better organization so that trademarks would not be lost, those concerns were not addressed at that time.

12. The authority to manage, control and use Sherwin-Williams' patents was also delegated to the divisions. However, because the patents were usually used by one division, Sherwin-Williams had not experienced any problems with their management.

Creation of SWIMC, Inc. and DIMC, Inc.

13. Mr. Robert E. McDonald, admitted as an expert in intellectual property law, is a chemist and a trademark and patent attorney who has been employed by Sherwin-Williams since 1971.[2] During 1990 and 1991, he was petitioner's Senior Corporate Counsel of Patents and Trademarks. Currently, he is the Associate General Counsel of Patents and Trademarks.

We modify finding of fact "14" of the Administrative Law Judge's determination to read as follows:

> 14. In mid-1990, an idea for the creation of separate corporations, SWIMC and DIMC, to be incorporated in Delaware to hold and manage the Marks was presented to Mr. McDonald by Steven Tan, a former attorney in petitioner's intellectual property office, and David Cummings, petitioner's Manager of Tax Planning and Special Projects. The idea was also presented to and discussed with, among others, petitioner's Chief Financial Officer, Thomas Miklich, and General Counsel, Larry J. Pitorak.[3]

[2] Mr. McDonald is also an inventor who holds two American patents and one Canadian patent in his own name.

[3] We modified finding of fact "14" to more accurately reflect the record.

16. Mr. McDonald had neither seen any promotional materials for the creation of trademark holding companies in Delaware, nor read any articles “touting” the tax benefits of forming Delaware holding companies when he began considering whether separate trademark companies should be formed.

17. At the time that the formation of SWIMC and DIMC was under consideration, concerns were expressed regarding the separation of the Marks from Sherwin-Williams and the risk that the separation might be considered a “naked assignment” or “naked license.” Having a “naked assignment” or “naked license” could result in the loss of the Marks. A “naked assignment” is a transfer of a trademark without its related goodwill. A “naked license” is a transfer of the right to use a trademark without retention of control over the trademark.

18. After research, Mr. McDonald determined that if the assignment of the Marks to SWIMC and DIMC and the license-back of the Marks to petitioner were properly structured and abided by there would be no “naked license” or “naked assignment” problem.

19. Discussions continued, and it was decided that an information gathering trip to Wilmington, Delaware by Sherwin-Williams’ personnel was necessary for a comprehensive analysis of the benefits that could be realized by creating separate corporations to hold and manage the marks. Meetings were scheduled with various business and legal professionals. During that summer of 1990 information-gathering trip, Messrs. McDonald and Cummings met with bankers and attorneys, including Mr. Gordon Stewart, and also Dr. Donald Puglisi, a Delaware resident with substantial investment management experience.

20. Mr. Stewart and his law firm Duane, Morris & Hecksher ("Duane, Morris")[4] were interviewed by Messrs. McDonald and Cummings regarding Sherwin-Williams' possible engagement of that firm to provide legal services in connection with the formation of two trademark protection corporations. During that interview, other considerations discussed included the advantages in having Delaware as the corporations' commercial domicile.

21. Dr. Puglisi met with Messrs. McDonald and Cummings, in Delaware, during the summer of 1990, regarding the trademark protection corporations that Sherwin-Williams was considering establishing. Prior to that meeting, Dr. Puglisi had sent his *curriculum vitae* to Messrs. McDonald and Cummings. At that meeting, the subject of taxes was not brought up. Rather the discussions focused mainly on Dr. Puglisi's investment management, general management and administrative skills.

22. By that time, Dr. Puglisi already had 18 years experience in managing large investment portfolios and in other administrative aspects of business management. In addition, Dr. Puglisi was a full professor of finance at the University of Delaware. He was also the owner of Puglisi and Associates, Inc. Puglisi and Associates, which employed two associates, provided services as the United States representative for foreign corporations and foreign governments issuing securities in the United States. Puglisi and Associates continues to provide those services. In 1992, Dr. Puglisi became the MBNA America Professor at the University of Delaware, an endowed chair he still holds. In 1997, Dr. Puglisi was appointed by Delaware's Governor and confirmed by Delaware's Senate as a Commissioner on Delaware's Public Service

[4]Duane, Morris is a Delaware law firm. In 1994, Mr. Stewart resigned his partnership position at Duane, Morris and established Stewart & Associates, a professional law association, located in Wilmington, Delaware.

Commission. He continues to serve as a Commissioner on Delaware's Public Service Commission.

23. Based on the discussions that took place at that meeting, Dr. Puglisi understood that the purposes for forming the corporations were to provide oversight and management of the Marks and to ensure that the royalty income from those Marks was properly invested. In addition to discussing Dr. Puglisi's credentials, hostile takeovers were also discussed and Dr. Puglisi noted that there were potential benefits that forming trademark protection corporations might afford a company faced with a hostile takeover attempt.

25. Delaware sets the national standard for corporate law because of its widely-known provisions. Delaware also has a technologically advanced Secretary of State's office, providing quick access to filed documents, and is often the jurisdiction of choice for hearing intellectual property matters.

We modify finding of fact "26" of the Administrative Law Judge's determination to read as follows:

> 26. Sherwin-Williams was sensitive to the potential threat of a hostile takeover. After the Gulf and Western hostile takeover attempt was thwarted, various investment bankers circulated books on Sherwin-Williams to entice other potential bidders to consider a takeover.[5]

27. Prior to the transfer of the trademarks to SWIMC and DIMC, petitioner's intellectual property office kept a computerized docketing system that tracked information for its trademarks, including the name of the trademark, description of what action was required and when, if it was completed or not and registrations. However, many common law trademarks used by the various divisions were not listed in that docketing system. When it was decided that

[5]We modified finding of fact "26" by deleting the last two sentences as not supported by the record.

the domestic Marks should be transferred to SWIMC and DIMC, Sherwin-Williams' legal department reviewed the labels and promotional materials used by each division to ascertain the number of common law trademarks actually being used by the various divisions. It took Sherwin-Williams three to four months to assemble all of the domestic Marks that it transferred to SWIMC and DIMC.

We modify finding of fact "28" of the Administrative Law Judge's determination to read as follows:

> 28. Sherwin-Williams invested its cash on an overnight basis. Those short-term investments were conservative in nature and, therefore, did not generate maximum returns. Sherwin-Williams did not have the in-house expertise to improve returns on longer-term investments or to establish flexible financing options.[6]

30. Approximately 95% of Sherwin-Williams' sales were domestic. Therefore, it was decided that the initial focus of the restructuring of the management of the Marks should be on the approximately 550 domestic Marks owned by Sherwin-Williams.

31. In the Fall of 1990, Messrs. Miklich, McDonald and Cummings presented the idea for the formation of SWIMC and DIMC to Mr. Ivy. At that meeting, Mr. Ivy was presented with a single-page bullet list of the reasons for creating the two subsidiaries. That list was used by those individuals and Mr. Ivy as a "talking list" in their discussion of each of the reasons for the creation of SWIMC and DIMC. Mr. Ivy did not create a file as result of that meeting and he did not retain a copy of the "talking list." He had seen copies of the "talking list" floating around, but did not know where it was on June 30, 1999, one of the days he testified. At that meeting he agreed to be a director of both SWIMC and DIMC.

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[6]We modified finding of fact "28" by deleting the last two sentences as not supported by the record.

Formation of SWIMC and DIMC

32. Once it was determined that the formation of two separate corporations to manage and protect the Marks made good business sense, the decision was made to present the proposal for the formation of two investment management and trademark protection corporations to Sherwin-Williams' Board of Directors for its consideration.

33. In support of the proposal, Messrs. McDonald and Cummings were involved in the preparation of a business plan which outlined the benefits that could be achieved by the creation of two trademark management and protection corporations. The record includes a copy of the business plan, dated January 18, 1991.[7] The plan lists 11 benefits that would result from establishing SWIMC and DIMC. It also contains a summary of, among other things, the steps necessary for the formation of the two investment management and trademark holding subsidiaries and the various activities and services necessary for the operation of the two subsidiaries. A summary schedule of the estimated costs is also included in the business plan. The business plan does not identify any disadvantages associated with the proposed formation of the two subsidiaries.

34. Louis E. Stellato, then Assistant Secretary and Corporate Director of Taxes, presented the proposal to Sherwin-Williams' Board of Directors whose members included, among others, current or former (retired) chairmen/chief executive officers and current or former (retired) high-level executive officers of various large corporations.

35. On January 23, 1991, Sherwin-Williams' Board of Directors adopted resolutions that would allow for the establishment of two investment management and trademark holding

[7] A jumbled copy of the business plan is part of the Division's Exhibit "J."

subsidiaries, the assignment of Sherwin-Williams' domestic trademarks, trade names and service marks and all goodwill associated therewith to those subsidiaries and petitioner's nonexclusive licensing back of the transferred Marks in return for the payment of royalties.

36. The minutes of the January 23, 1991 meeting of Sherwin-Williams' Board of Directors state that the benefits of forming two corporations to hold and manage the Marks are to: (i) improve quality control oversight and increase efficiencies with regard to the Marks by virtue of having profit centers separate from Sherwin-Williams; (ii) provide easier profit analyses of Sherwin-Williams by having profit centers for the Marks which are separate from it; (iii) enhance the ability to enter into third-party licensing arrangements at advantageous royalty rates; (iv) increase overall profitability because of the availability of Delaware's corporate income tax exemption for investment and trademark holding companies; (v) separate and centralize investment management to maximize investment returns associated with the Marks; (vi) provide additional avenues that might be used when acquiring companies; (vii) provide additional financing vehicles; (viii) use the well-developed body of corporate law and expeditious legal system in Delaware; (ix) insulate the Marks from Sherwin-Williams' liabilities; (x) have flexibility in preventing a hostile takeover; and (xi) increase liquidity.

We make the following additional findings of fact.

> As to the business plan's suggestion that improving oversight of quality control would be a benefit derived from creation of the Delaware subsidiaries, following the assignment and license-back transaction, the quality control function was outsourced to an accounting firm. This outsourcing did not occur until well into the second year after the assignment and license-back transaction and the accounting firm which was chosen had no special expertise in the area and did not do any quality control work in the year it was retained. There was no quality control activity performed by either SWIMC or DIMC in the interim.

Even after the outsourcing of a quality control role, Sherwin-Williams remained fully engaged in quality control functions.

With respect to increasing efficiencies with regard to the trademarks, as a result of the January 1991 assignments, the trademarks of Sherwin-Williams were distributed over three companies rather than one.

Following the assignments and license-back agreements, management and control of the trademarks was separated from SWIMC and DIMC's legal ownership of the Marks. Sherwin-Williams acted as a trademark service provider providing overall maintenance of the Marks and various registrations, licensing and legal services connected therewith. Sherwin-Williams continued to maintain the centralized docketing system to track all of the Marks, on advertising and on trademark litigation.

With regard to the business plan's listed benefit of enhancement of third-party licensing arrangements, there is no evidence in the record that either SWIMC or DIMC ever actively solicited third-party licensing opportunities. Dr. Puglisi testified that neither subsidiary ever had any third-party licensing marketing plan or program. Instead, the subsidiaries relied on Sherwin-Williams to learn of potential licensing opportunities.

By the end of 1991, DIMC had not accumulated any royalty income from third-party licenses. In the same year, less than 1/10th of 1% of SWIMC's royalty income came from third-party licenses, and that amount included royalties from the preexisting license agreement with Taracorp, Inc. which had been assigned to SWIMC in conjunction with the original trademark assignments in January 1991. The same held true in 1992: DIMC had no third-party royalty income for the year and approximately 1/10th of 1% of SWIMC's royalty income was from third-party arrangements.

Dr. Shapiro and Mr. Bromberg testified that SWIMC and DIMC did not have the necessary information to make informed judgments as to whether third-party licensees could maintain the brand value proposition associated with the assigned trademarks and, thus, there could be no rational expectation that the subsidiaries could increase value and generate benefit by engaging in third-party licensing.

> With respect to the use of the subsidiaries as additional financing vehicles, the certificates of incorporation and bylaws of both SWIMC and DIMC actually prohibited such use.
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> Additionally, Sherwin-Williams' loan agreements with creditors both before and after the creation of SWIMC and DIMC precluded Sherwin-Williams from using the income from its trademarks as security.
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> The business plan also included among its listed benefits the use of the entities to insulate the trademarks from Sherwin-Williams' liabilities and to afford protection from hostile takeover. SWIMC was at all times a 100% wholly-owned subsidiary of petitioner, while a full 85% of the stock of DIMC was owned directly by petitioner with the remaining 15% held by another of Sherwin-Williams' subsidiaries. Both Dr. Shapiro and Mr. Bromberg opined that transferring assets from Sherwin-Williams to SWIMC and DIMC would not prevent Sherwin-Williams' creditors from seizing those assets because its stock in the subsidiaries is an asset owned by Sherwin-Williams and, thus, could be seized by that company's creditors.
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> With respect to the hostile takeover benefit enunciated in the business plan, Dr. Shapiro stated that the use of the subsidiaries would not afford protection of assets as the takeover bidder would simply acquire the stock of the subsidiaries, thereby acquiring the subsidiaries' assets.

37. It was decided that the two corporations would be named SWIMC, Inc. (for Sherwin-Williams Investment Management Company) and DIMC, Inc. (for Dupli-Color Investment Management Company). SWIMC, the wholly-owned subsidiary, would own the non-aerosol Marks. While DIMC, which would be 85% owned by Sherwin-Williams and 15% owned by Dupli-Color Products Company ("Dupli-Color") (a wholly-owned subsidiary of Sherwin-Williams), would own the aerosol marks.

38. The organizational documents, e.g., certificates of incorporation, Board resolutions of the incorporator, bylaws, agreements regarding capital contributions, license agreements,

banking resolutions and stock certificates, were prepared for SWIMC and DIMC by Mr. Stewart.

39. On January 30, 1991, Mr. Stewart, as incorporator, executed two certificates of incorporation, one for SWIMC, Inc. and the other for DIMC, Inc. Both certificates of incorporation were filed with the Office of Secretary of State of the State of Delaware on January 31, 1991.

40. The purpose and activities of SWIMC and DIMC are set forth in their certificates of incorporation and bylaws. The purpose of SWIMC and DIMC is to engage in any lawful act or activity for which corporations may be organized under Delaware's General Corporation Law. However, the activities of SWIMC and DIMC are confined to the maintenance and management of their respective intangible investments and the collection and distribution of the income from such investments or from tangible property physically located outside of Delaware.

41. The certificates of incorporation of both SWIMC and DIMC, as originally executed, each contain the following Article ELEVENTH:

> The corporation may not lease, sell, exchange, transfer, license, assign (except to affiliates), or dispose of any of the assets of the Corporation (except for assets having a value under $2,000), without the approval of the holders of a majority of shares of the corporation's capital stock issued and outstanding at the time. Nothing in this Article ELEVENTH shall restrict the disbursement of funds from the corporation's accounts with financial institutions as and when approved by the directors in accordance with the bylaws.

42. The certificates of incorporation also provide that SWIMC and DIMC are to have no power and could not be authorized by their stockholders or directors to undertake any activities that would lead them to lose tax exempt status in Delaware or to be subjected to taxation in any other state.

Selection of Directors and Officers

43. John L. Ault, Mr. Ivy and Dr. Puglisi were named to SWIMC's and DIMC's original boards of directors. Mr. Stewart was added as a board member of each corporation shortly after incorporation. Only two of the four directors appointed to each board, Messrs. Ault and Ivy, were affiliated with Sherwin-Williams.

44. Mr. Ault has been employed by Sherwin-Williams for 23 years and is Vice President and Corporate Controller of Sherwin-Williams, a position he also held in 1991, when SWIMC and DIMC were formed. Mr. Ault heard about the idea of creating SWIMC and DIMC from his superior, Mr. Miklich, in January of 1991. Messrs. Miklich and Ault verbally discussed the idea for a couple of hours. During that conversation, Mr. Miklich would occasionally refer to a pile of papers that were not shown to Mr. Ault. At that time, Mr. Ault was asked by Mr. Miklich to become a board member of the companies because he had an excellent financial background that would be valuable to the companies responsible for managing and investing significant funds. Mr. Ault accepted the positions on the boards because they would afford him the opportunity to expand his experience regarding the safekeeping of valuable assets, i.e., the Marks.

45. Mr. Ivy, Vice President of Corporate Planning and Development and then Treasurer of Sherwin-Williams, was invited to become a board member of the companies because he had often expressed concern over the way Sherwin-Williams had managed its Marks. Although the demands on his time were great, Mr. Ivy agreed to serve as a director of the companies responsible for managing and protecting the Marks.

46. Mr. Stewart was selected as a director of each board because of his expertise in Delaware law.

47. Since one of the reasons for forming SWIMC and DIMC was to maximize the rates of return on investments, Dr. Puglisi was selected as both an officer and director of the corporations. His significant financial and investment experience, his management skills and his ability to be an effective decision maker motivated his selection as an officer and director of both companies.

We modify finding of fact "48" of the Administrative Law Judge's determination to read as follows:

> 48. Given SWIMC's and DIMC's purported focus upon the management of the Marks and investment of funds, the fact that Dr. Puglisi had no prior experience in trademark law or the paint business was not viewed as critical.[8]

49. The first meetings of the boards of directors of both SWIMC and DIMC took place on February 1, 1991. The directors of each company ratified the acts of the incorporator and elected officers. At that time, Mr. Ault was elected Chairman of SWIMC and DIMC. Dr. Puglisi was elected President and Treasurer of SWIMC and DIMC. Mr. Stewart became the Secretary of both SWIMC and DIMC and Mr. Michael Semes, an associate at Duane, Morris, was elected as SWIMC's and DIMC's Assistant Secretary.

51. Employment agreements were entered into by SWIMC and DIMC with each of the officers. Under the terms of each employment agreement, Dr. Puglisi, as President and Treasurer, was to receive $18,000.00 per year for his services; while Mr. Stewart and Mr. Semes were each to receive $500.00 per year for their services as Secretary and Assistant Secretary, respectively.

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[8]We modified finding of fact "48" by deleting the last two sentences as irrelevant.

52. The minutes of the initial meeting of SWIMC's board of directors indicate that Sherwin-Williams transferred $50,000.00 and its ownership right, title and interest in certain Marks, "and all goodwill associated therewith, along with all registrations, pending registrations and a license thereof and a licensing agreement" in exchange for 1,000 shares of SWIMC stock, par value $0.01. No gain was recognized by Sherwin-Williams on this exchange pursuant to Internal Revenue Code ("IRC") § 351.

53. By an Assignment Agreement dated January 31, 1991, Sherwin-Williams assigned "all of its ownership right, title and interest in and to the SW Property (as defined in the [SWIMC] Capital Contribution Agreement), including all registrations and pending registrations therefor, which are more particularly identified on Exhibit A attached hereto." The Exhibit A attached to the agreement refers to the "tradenames, trademarks and service marks and all goodwill associated therewith . . . identified on the attached list." No list is attached to the agreement that is in the record. However, the record does include the Agreement Regarding Capital Contribution Between The Sherwin-Williams Company and SWIMC, Inc. ("SWIMC Capital Contribution Agreement") referenced in the Assignment Agreement. Approximately 420 Marks that constitute a part of the SW Property are identified on a list that is attached to Exhibit A of the SWIMC Capital Contribution Agreement.

54. The minutes of the initial meeting of DIMC's board of directors indicate that Sherwin-Williams transferred $42,500.00 and its ownership right, title and interest in certain Marks, "and all goodwill associated therewith, along with all registrations, pending registrations and a license thereof" in exchange for 850 shares of DIMC stock, par value $0.01. No gain was recognized by Sherwin-Williams on this exchange pursuant to IRC § 351. The minutes also indicate that

Dupli-Color transferred $7,500.00 and its ownership right, title and interest in certain Marks, "and all goodwill associated therewith, along with all registrations, pending registrations and a license thereof" in exchange for 150 shares of DIMC stock, par value $0.01.

55. By an Assignment Agreement dated January 31, 1991, Sherwin-Williams assigned 120 Marks to DIMC.

56. The assignments of the Marks to SWIMC and DIMC were recorded in the United States ("U.S.") Patent and Trademark Office. As a result of the assignments, SWIMC and DIMC became the owners of the Marks.

57. At both SWIMC's and DIMC's initial meetings, the directors authorized and directed Dr. Puglisi and Mr. Stewart to, among other things, engage a financial institution to perform custodial services; open a checking account at the Bank of Delaware; enter into agreements for the provision of services related to the management and protection of the Marks; and to enter into license agreements with Sherwin-Williams for its licensing of certain Marks on a nonexclusive basis upon the payment by Sherwin-Williams of royalty fees that represented a "fair value" for the use of those Marks.

58. At those initial meetings, Dr. Puglisi and Mr. Stewart were each given the authority to write checks up to the amount of $2,000.00 on the corporate checking accounts. Amounts in excess of that amount required the approval of either Mr. Ault or Mr. Ivy, the two non-officer directors.

The License Agreements

59. On February 1, 1991, license agreements were entered into pursuant to which SWIMC and DIMC would license certain of their respective Marks to Sherwin-Williams ("License Agreements"). Pertinent provisions of the License Agreements are set forth below.

60. Section 1(c) of each of the License Agreements grants Sherwin-Williams ("licensee") the nonexclusive right to use certain Marks and all goodwill associated therewith

> in connection with the manufacture, distribution and sale of products and services in the United States as approved by Licensor (herewith such approved products and services are collectively referred to as "Approved Products"). It is expressly understood that Approved Products shall include all products and services which were provided, manufactured, distributed or sold by Licensee in conjunction with one or more of the Trademark(s) prior to the date of this Agreement and shall also include such other products and services which fall within the description of goods of the corresponding registrations or common law usages of the Trademark(s), provided such products and services comply with the standards determined by Licensor as set forth herein and/or issued pursuant to this Agreement. The standards to be determined by Licensor shall include, without limitation, the quality of the goods or services, the labeling and advertising uses of the Trademark(s), and the performance requirements of new products or services intended to be provided under the Trademark(s). Licensor acknowledges that such policies as currently followed by Licensee are satisfactory to Licensor, but Licensor reserves the right to withdraw its approval or amend its standards at any time.

61. Section 2 of each of the License Agreements sets forth quality control standards that must be maintained with respect to the "Approved Products provided in conjunction with the Trademark(s), in order to enhance goodwill as symbolized by the Trademark(s)." SWIMC and DIMC are given, among other things, the right to (a) "approve all advertising in connection with the Approved Products," (b) issue quality control standards, "together with accompanying

quality control policies and procedures" and (c) demand "descriptions of all activities currently performed and/or being completed by Licensee relating to the Approved Products and of the manner of performing same," in order to "determine whether the high standards and quality control measures are being maintained by Licensee." The License Agreements stipulate that "Licensor (or its authorized representative) shall be the sole judge of whether the activities of Licensee have complied or are complying with the aforesaid high standards and quality control measures."

62. Section 2(h) of each of the License Agreements provides:

> [i]n the event that Licensee at any time makes any changes in its business procedures that may alter the performance of any of the services or the delivery of products upon or in relation t [sic] which Licensee uses or intends to use the Trademark(s), Licensee shall promptly give notice in writing thereof to Licensor or its authorized representative, so that Licensor or its authorized representative may determine through supplemental investigation, if necessary, in the Licensor's sole judgment, whether Licensee is conforming to the high standards and quality control measure [sic] which have been set forth herein, and Licensee shall abide by the decision of Licensor or its authorized representative in this respect.

63. Under the terms of each license agreement, Sherwin-Williams agrees "to pay Licensor for the license of the Trademark(s) for each calendar quarter a royalty ('Royalty Fees') in the percentage amount set forth on Exhibit C, of Licensee's Royalty Base." Exhibit C sets forth the following royalty rates based upon sales by individual divisions: Stores 2.5%; Consumer 2.5%; Automotive 4.5%; Chemical Coatings 1.0% and Specialty Products 4.0%.

Section 3(b) of each License Agreement defines the royalty base as "the invoiced sales value of all Approved Products sold" by the licensee less such items as returned, lost or damaged Approved Products, and is therefore the same as what is generally considered to be net sales.

Section 3(c) of the License Agreements requires Sherwin-Williams to pay the royalty fees due for each quarter within 60 days of the end of each calendar quarter. Along with the payment, Sherwin-Williams must submit an itemized statement "setting forth sales and production reports in sufficient detail for verification, and showing the basis upon which said Royalty Fee is determined and payable."

64. The License Agreements are for a ten-year period, although they can be terminated by either party at any time by reason of the breach or default of the other party. At the end of the 10-year period, SWIMC and DIMC have the right to terminate the agreements with six months written notice of termination, at which point Sherwin-Williams would be required to "immediately cease to use the Trademark(s) for any and all purposes."

65. SWIMC and DIMC licensed to Sherwin-Williams only those Marks that were going to be used by Sherwin-Williams. For example, the "Dutch Boy" Marks that were licensed to Taracorp, Inc. ("Taracorp"), a third party, were not licensed to Sherwin-Williams.

Establishment of Royalty Rates

66. In November 1990, Sherwin-Williams engaged the services of American Appraisal Associates ("AAA"), the world's largest independent appraisal firm, to determine the fair market value of the domestic trademarks and trade names of Sherwin-Williams. Prior to the November 1990 engagement, AAA had provided Sherwin-Williams with valuations for various pieces of real estate. Sherwin-Williams never told AAA that it wanted any particular royalty rates and AAA's fees were not dependent upon the results of its appraisal.

67. On December 7, 1990, Mr. McDonald sent Diane Benkler of AAA "the April 2, 1990 list of abstracts of [Sherwin-Williams'] foreign license agreements." That list is not part of the record.

68. On or about January 15, 1991, the conclusions reached by AAA in its valuation study were provided to Sherwin-Williams.

69. By letter dated February 4, 1991, a draft of AAA's appraisal report was remitted to Sherwin-Williams. The letter invited comments from Sherwin-Williams. The record does not include a copy of the draft appraisal report. It is AAA's policy to supply a draft appraisal report after the conclusions are given to the client.

70. Based upon AAA's valuation study, valuations were placed on the Marks and royalty rates were determined with respect to the Marks. The appraisal report, furnished on April 10, 1991, determined that, as of January 31, 1991, the fair market value of Sherwin-Williams' domestic trademarks was $328,000,000.00 and the appropriate royalty rates based on sales by individual divisions were: Stores 2.5%; Consumer 2.5%; Chemical Coatings 1.0%; Automotive 4.5% and Specialty Products 4.0%.

71. In determining the fair market value of the Marks, AAA first determined the appropriate royalty rates for the Marks. A search was made for comparable royalties being charged for the use of similar marks. Next, the royalty rates derived from an analysis of the comparables were refined by subjecting them to a reasonability test. The royalty rates used in determining the fair market value of the Marks were within the ranges determined by the reasonability test and the comparability study.

72. Mr. Richard Billovits, a vice president and principal at AAA, testified on behalf of petitioner regarding the AAA report. Although he did not participate in the preparation of the report, Mr. Billovits did review the work papers used in the preparation of that report. However, he did not recall seeing the draft appraisal report in the file containing the work papers. Mr. Billovits was accepted as an expert in the appraisal of intangible assets.

73. The AAA study was performed using a form of the income approach known as the "relief from royalty approach." In that approach, a determination is first made of the arm's-length royalty rates that a holder of trademarks would charge to a person who wanted to license the trademarks. The royalty rates determined are then applied to the projected sales to determine the expected royalties that would be required to be paid if the owner of the trademarks did not own them and was required to license them. These amounts are then discounted to derive their present value.

74. AAA began its determination of the royalty rates for the domestic trademarks by trying to find comparable license transactions in either paint or similar fields, but was unable to find any comparable third-party transactions. However, Sherwin-Williams did supply AAA with the abstracts of 57 foreign third-party licenses for the use of Sherwin-Williams' Marks. The actual license agreements were never furnished to AAA. The report does not provide any details about the licenses, including the names of the licensees or the terms of the agreements.

75. AAA reviewed and analyzed the foreign license abstracts. After elimination of a 0.5% rate for a license for the use of the "Dutch Boy" name on lead pipes, which had expired in 1987 and was not considered comparable to a license of a Mark for use on paint products, the rates were determined on a divisional basis and ranged from 1% to 7% . In refining the rates on

a divisional basis, AAA analyzed the operating profits of each of Sherwin-Williams' divisions and applied the rule of thumb used in evaluating trademark licenses (i.e., that a licensee will typically pay between 25% to 33⅓% of its operating profit for its right to use a trademark). AAA determined the following ranges of royalty rates: for Stores Products a range of 1.9% to 2.6%; for Consumer Products a range of 2.1% to 2.8%; for Chemical Coatings Products a range of 0.2% to 1.5%; for Automotive Products 3.7% to 4.9%; and for Specialty Brands a range of 3.5% to 4.6%. Instead of using the entire range of 25% to 33⅓%, AAA chose 30% as the appropriate range and applied 30% to the average operating profit of each of the divisions. The royalty rates determined for each division were: Stores Products 2.5%; Consumer Products 2.5%; Chemical Coatings 1%; Automotive Products 4.5%; and Specialty Brands 4%.

76. Mr. Billovits corroborated the arm's-length royalty rates determined in the appraisal by further evaluation of the abstracts of the 57 foreign licenses. He reviewed the Sherwin-Williams 1991 Annual Report and determined that none of the foreign licensees were listed as subsidiaries. Mr. Billovits also checked with Sherwin-Williams to determine if it had an ownership interest in any of the licensees. He was informed by Sherwin-Williams' personnel that Sherwin-Williams did not control 50% of the stock of any of the foreign companies that were parties to the licenses, although Sherwin-Williams had up to a 20% interest in a few of the licensees.

77. Mr. Billovits admitted that a company may have control over another business through means other than stock ownership. He admitted that provision of technology is one way to exert a controlling interest over another company. He also admitted that the value of a trademark depends in part on the size of the market within which it is employed.

78. Mr. Billovits received assurances from Sherwin-Williams' personnel that 25 of the foreign license agreements had no provisions for the transfer of technology in conjunction with the trademarks or had a provision for the transfer of only low-level technology. He determined the royalty rates of the 25 foreign license agreements to be within the range of 1% to 5%. Based on his determination that the foreign royalty rates ranged from 1% to 5%, he concluded that the royalty rates determined by AAA for the various divisions represented arm's-length royalty rates.

79. AAA then valued the trademarks using the relief from royalty method. The royalty rates determined for each division were applied to 10-year projections of revenue on a divisional basis, and the after-tax royalty savings related to the divisional sales were discounted to present value at a 20% adjusted cost of equity. Since trademarks have an unlimited life, AAA determined the value beyond year ten by taking the division's final year's royalty savings as a result of owning a trademark and capitalized it at the discount rate less the stabilized growth rate that varied by division, but was either 4% or 5%. Based on its computations, AAA determined the fair market value of Sherwin-Williams' domestic trademarks to be $328,000,000.00.

80. The appraisal report includes an explanation of how the adjusted cost of equity was determined. "The discount rate was developed in a process that incorporated aspects of economic theory, capital budgeting techniques and the Arbitrage Pricing Theory ("APT")."[9] The formula used to calculate the equity discount rate was Re = Rf + [B x (Rm – Rf)], where Re equals the required return (cost of equity); Rf equals the risk-free rate of return; B equals Beta, a statistical measure of the sensitivity and relationship between the subject (company and

[9] The APT is a multi-factor asset pricing model developed by Stephen Ross in 1976. It is a method used to estimate the risk premium associated with an asset.

comparative companies) risk and the market viewed as one; and Rm – Rf equals the expected return of the market in excess of the risk-free rate.

The risk-free rate of return was based on long-term treasury bonds that, at the appraisal date, were priced to yield 8.08%. AAA estimated the expected return of the market in excess of the risk-free rate to be 7.29%, based on historical studies of actual returns required of equity investments over long-term bond investments. The APT Beta factor for comparable companies in the coatings industry was determined to be 1.366. The report does not identify the companies used or the betas for those companies. Utilizing these three components, an average cost of equity return was determined as follows: 8.08 + (1.366 x 7.29) = 18.04%. AAA added a 2% additional risk premium on the theory that trademarks are "elements of going concern and more subject to public volatility" and determined the adjusted cost of equity to be 20%.

81. Mr. Billovits explained that the method actually used by AAA to determine the discount rate was a combined methodology of APT and the Capital Asset Pricing Method ("CAPM"). He did not explain the equation for this hybrid formula. According to Mr. Billovits, the beta used in the report was based on an average beta for four companies and that the beta data for the comparables was furnished by an unidentified consulting firm. The documents from that consulting firm are not in the record. With respect to the 2% risk premium factor, Mr. Billovits stated that it is commonly used to show the risk of trademarks. According to Mr. Billovits, trademarks are one of the more risky assets that a business can own. This is because trademarks will drop in value more than other assets of a company when it experiences significant operational problems.

82. Mr. Billovits, as an expert in valuing intangible property, opined that the royalty rates charged by SWIMC and DIMC to Sherwin-Williams constituted arm's-length rates.

Services Agreement

83. On February 1, 1991, SWIMC and DIMC each contracted with Sherwin-Williams to provide certain trademark services for them. Under the terms of each Services Agreement, Sherwin-Williams, as trademark service provider, is to provide various trademark support services, including identifying renewal and affidavit dates for the trademarks, providing registration services, licensing assistance and advice relating to trademark protection and enforcement.

84. Each Services Agreement has a Fee Schedule that sets forth the charges for the services to be performed by Sherwin-Williams as trademark service provider. The following charges for the services were set in accordance with the American Intellectual Property Law Association ("AIPLA")[10] guidelines:

Filing trademark application	$ 290.00
Prosecution of trademark application	$ 415.00
Trademark appeal to Board	$2,050.00
Trademark section declarations	$ 220.00
Trademark renewal applications	$ 235.00
All other work shall be billed at $140.00 per hour.	

[10] AIPLA is an independent trade organization that conducts a survey of legal fees for various legal services in different geographical areas.

85. At SWIMC's and DIMC's request, Sherwin-Williams did, among other things, provide the trademark docketing services and the maintenance reminder system to ensure timely renewals of the Marks, helped with the licensing enforcement and provided legal interpretation.

86. Sherwin-Williams provides SWIMC and DIMC with quarterly invoices that are paid by check.

87. At its April 30, 1991 meeting, SWIMC's directors authorized its President and Secretary "upon consent of the licensee" Sherwin-Williams, to amend the royalty payment and sales reporting provisions (Section 3[c]) of the License Agreement, as follows: (1) the licensee was to provide a sales production report by Division within 60 days of the end of each calendar quarter, and (2) payment of the royalty would be due within 30 days of an invoice sent by SWIMC.

88. Although the Division subpoenaed "all inter-company agreements," Sherwin-Williams did not produce any amendment to the SWIMC license agreement embodying this change in the due date of Sherwin-Williams' royalty payments.

89. The change in the due date for petitioner's royalty payments was needed because Sherwin-Williams could not capture the information and get it to Dr. Puglisi in a timely manner to allow him to determine the correct amounts of royalties to be billed to Sherwin-Williams. Although Dr. Puglisi committed himself to trying to find the amendment to the SWIMC License Agreement that changed the payment paragraph, no such amendment was produced by Sherwin-Williams at the hearing.

90. The minutes of DIMC's April 30, 1991 directors' meeting also indicate that Dr. Puglisi and Mr. Stewart were authorized to amend Section 3(c) of the respective License

Agreements with Sherwin-Williams and Dupli-Color. The amendment to DIMC's License Agreement reflecting the changes to Section 3(c) is not in the record.

91. The record includes copies of the royalty billing records for the period in issue. Review of those records indicates that typically Sherwin-Williams sent SWIMC and DIMC the sales production reports within 30 to 45 days of the end of the quarter and SWIMC and DIMC sent invoices to Sherwin-Williams about 60 days after the end of the quarter, demanding payment within 30 days of the date of the invoices. Starting in August 1991, Sherwin-Williams began sending Dr. Puglisi, as President of SWIMC and DIMC, quarterly estimates of sales covered by its licensing agreements with SWIMC and DIMC.

92. The July 29, 1991 SWIMC Board of Directors' minutes contain a discussion about the dissolution of Sherwin-Williams' Chemical Coatings Division. The minutes indicate that the net sales out of the Chemical Coatings Division had been "approximately $60 million of which approximately 75% would now be sold under the Stores Division, with the remaining 25% sold under the Automotive Division." The minutes also indicate that the directors discussed the appropriate method of determining the proper royalty rate for the sales formerly reported by the Chemical Coatings Division. The Board decided to leave the royalty rate unchanged, unless objective evidence of a lower royalty rate was presented by the licensee. SWIMC's Board directed that the License Agreement, upon the consent of the licensee, be amended to reflect the transfer of sales from the Chemical Coatings Division to the Stores Division and the Automotive Division. That amendment is not part of the record.

93. A review of the sales production reports sent to SWIMC by Sherwin-Williams indicate that, as of August 1991, sales were no longer reported for the Chemical Coatings Division.

94. A review of SWIMC's October 21, 1991 Board of Directors minutes indicate that Dr. Puglisi had received a letter of appraisal for the Chemical Coatings trademarks. According to the minutes, the sales from the Chemical Coatings Division were being included in sales from the Automotive and Consumer divisions and "the appraisal confirmed that no change in the royalty rate under the license agreement for those Divisions" was necessary.

95. During 1991, Sherwin-Williams contributed additional trademarks to SWIMC and DIMC.

On May 1, 1991, six additional trademarks were assigned to SWIMC. The License Agreement was amended to grant Sherwin-Williams the right to use those additional trademarks.

In 1991, Sherwin-Williams continued to acquire additional product lines including the assets of the "Cuprinol" product line of wood stains and preservatives from Ensign-Bickford Industries, Inc. and certain assets of Cook Paint and Varnish Company. On August 1, 1991, Sherwin-Williams assigned to SWIMC as an additional contribution of capital, the eight Marks related to the "Cuprinol" product line. The book value of those Marks was $515,000.00. The License Agreement was amended to grant Sherwin-Williams the right to use those additional trademarks effective as of August 1, 1991. The sales related to the "Cuprinol" trademarks were included in the sales production reports that Sherwin-Williams sent to SWIMC commencing on August 1, 1991.

On October 15, 1991, Sherwin-Williams assigned the “E-Prime” and “Interlock” trademarks to SWIMC. The License Agreement was amended to allow Sherwin-Williams to use those additional trademarks effective as of October 15, 1991.

On October 15, 1991, Sherwin-Williams transferred the “Rust Tough” trademark to DIMC. The License Agreement was amended to grant Sherwin-Williams the right to use that additional trademark effective as of October 15, 1991.

Operation of SWIMC and DIMC

96. On February 1, 1991, Dr. Puglisi executed a lease agreement for office space in Wilmington, Delaware. That office was solely SWIMC’s and DIMC’s; no other party shared the office with them. The two corporations shared an office (approximately 9 ft. by 9 ft. in dimension), Suite 522 in the Bank of Delaware Building, located at 300 Delaware Ave., Wilmington, Delaware. In 1991, the monthly rent was $750.00, the payment of which was split equally by SWIMC and DIMC. The Wilmington, Delaware office contained standard office equipment, including a desk and desk chair, two additional chairs, a filing cabinet and a telephone with two separate phone lines, one for SWIMC and the other for DIMC. In 1991, the telephone bills for the companies were nominal. All correspondence issued on behalf of either SWIMC or DIMC contained the Wilmington address. Additional services provided by the Wilmington landlord included the provision of a receptionist who answered and forwarded all SWIMC and DIMC calls as well as their mail to Dr. Puglisi at Puglisi and Associates, Inc.’s Newark, Delaware office. The companies continue to lease the office in Wilmington, Delaware.

97. In January 1992, for the convenience of Dr. Puglisi, additional office space was subleased at 1500 Casho Mill Road, Suite 3D, Newark, Delaware from Puglisi and Associates,

Inc. At that location, SWIMC and DIMC shared one office, approximately 10 ft. by 10 ft. in dimension, which contained a desk, a chair, a computer sitting on a small side table, a telephone and a wooden double-width file cabinet. No other party shared that office. The rent was $360.00 per year per company for the Newark office. Puglisi and Associates, Inc. has since moved to 850 Library Avenue, Newark, Delaware. SWIMC and DIMC continue to sublease an office, approximately 10 ft. by 10 ft. in dimension, from Puglisi and Associates, Inc.[11] The Newark office rent continues to be $360.00 per year per company.

We modify finding of fact "98" of the Administrative Law Judge's determination to read as follows:

> 98. During the period in issue, Dr. Puglisi conducted SWIMC's and DIMC's operations from his office in Newark where he kept all current records for both corporations.[12]

99. All of the Marks are registered to the address in Wilmington. The primary reason that office is maintained is that if a permanent address were not maintained, then every time SWIMC and DIMC were to move to a different location the official recordation of every SWIMC and DIMC Mark would need to be changed, a costly proposition. The Wilmington, Delaware office is used for the storage of historical records.

100. SWIMC and DIMC each opened checking and custodial accounts with The Bank of Delaware. The Marks were physically transferred into the Delaware custodial accounts. Each corporation paid the custodial fees assessed by the Bank of Delaware for the safekeeping of its

[11] The record is silent as to when Puglisi and Associates, Inc.'s lease expired at the Casho Mill Road location and the company moved to its current suite of offices at Library Avenue.

[12] We modified finding of fact "98" by deleting reference to Dr. Puglisi's conduct of business on behalf of the subsidiaries as requiring his daily attention since he was employed as basically a part-time employee on behalf of SWIMC and DIMC.

respective Marks. All royalty payments received by SWIMC and DIMC were deposited into their respective custodial accounts.

101. Deposit accounts at the U.S. Patent and Trademark Office were set up in the names of both SWIMC and DIMC for purposes of, among other things, registration and assignment of Marks. Each corporation's deposit account was funded and replenished via checks drawn on its respective checking account.

102. In 1991, as part of his responsibilities Dr. Puglisi maintained, among other things, each company's books; paid the bills; responded to all correspondence and telephone calls and prepared the monthly and quarterly financial statements that were presented to SWIMC's and DIMC's directors at the quarterly board meetings.

We modify finding of fact "103" of the Administrative Law Judge's determination to read as follows:

> 103. Subsequent to 1991, audits in accordance with generally accepted auditing standards and generally accepted accounting principles were rendered to SWIMC and DIMC by Wade & Santora, a certified public accounting firm located in Delaware. Wade & Santora was not related to and did no work for Sherwin-Williams. [13]

105. In addition to his responsibilities as Secretary of SWIMC and DIMC, Mr. Stewart provides legal services to those corporations. During 1991, legal services were provided by Mr. Stewart to both SWIMC and DIMC. Each corporation paid Duane, Morris for those services.

106. In 1991, Mr. Spiro Bereveskos, a trademark attorney in Indiana, also provided legal services to SWIMC.

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[13] We modified finding of fact "103" by deleting reference to the firm of Wade & Santora rendering quality control services since a specific discussion of that topic is addressed by a later set of facts.

107. Payroll tax returns and administrative filings were handled by SWIMC and DIMC.

108. SWIMC and DIMC paid their respective shares of the federal consolidated tax liabilities, pursuant to Tax Sharing Agreements they entered into with Sherwin-Williams. SWIMC and DIMC paid $8,505,749.00 and $1,351,941.00, respectively, in federal income taxes for 1991. According to the audited financial statement issued by Wade & Santora, SWIMC's and DIMC's current provisions for federal income taxes for 1991 were: $13,722,400.00 and $2,254,527.00, respectively.

109. By letters dated March 26, 1991, the Delaware Division of Revenue issued rulings that SWIMC and DIMC were exempt from Delaware income taxes in accordance with 30 Del. C. § 1902(b)(8).

110. Providers of services to SWIMC or DIMC received payment from SWIMC or DIMC for such services.

Corporate Form

111. In 1991, SWIMC and DIMC held separate quarterly meetings of their boards of directors in Delaware at the offices of Duane, Morris. The meetings occurred on the same day, one right after the other. Each corporation's initial board of directors meeting lasted 30 minutes. The April 30, 1991 and October 21, 1991 meetings lasted one hour for each corporation. The meetings held on October 21, 1991 each lasted 40 minutes. Minutes were taken of all meetings. As Secretary of SWIMC and DIMC, Mr. Stewart maintained the corporate minute books for each company. Dr. Puglisi retained the corporate minute books for each company at the Wilmington office. Mr. Stewart retained a duplicate set of minutes for each company.

112. Although Delaware law permits telephone participation at board meetings, SWIMC's and DIMC's directors were always physically present.

113. Prior to each meeting an agenda was provided to the directors, as were certain reports that would be discussed at the meeting, including lists of investments and financial statements and minutes from the prior meeting. The reports discussed the status of various Mark-related matters, including oppositions and infringements, and would provide a 12-month forward-look of Marks for which some action, such as renewals, might be needed.

114. During such meetings held in subsequent years, SWIMC's and DIMC's boards of directors elected the corporations' officers and discussed the respective company's business. Those meetings would generally last about an hour-and-a-half to two hours for each corporation. At those subsequent meetings, the external auditors would often be present. Minutes were taken for all meetings. All meetings were held in Delaware.

115. In addition to the quarterly Board meetings, an annual shareholder meeting took place in Delaware for each corporation. Minutes were taken for all such meetings.

Trademark Maintenance and Protection

116. In its role as trademark service provider, Sherwin-Williams maintained the dockets of Marks owned by SWIMC and DIMC and notified them when action needed to be taken, such as when an affidavit of use needed to be filed.

117. During 1991, SWIMC and DIMC paid for and filed trademark applications and renewals. Registration fees and other charges were paid from deposit accounts that SWIMC and DIMC each maintained with the U.S. Patent and Trademark Office. That practice continues to this day.

We modify finding of fact "118" of the Administrative Law Judge's determination to read as follows:

> 118. Since the formation of SWIMC and DIMC, no Marks have unintentionally expired.[14]

119. When a potential infringer is identified, Dr. Puglisi determines whether or not to take measures against the potential infringer. Typically, infringers are paint companies or painters that state on their advertisements that they use paint carrying SWIMC's or DIMC's Marks. Often these infringers are unaware that they have done anything improper, and a letter from, or authorized by, Dr. Puglisi is all that is needed to rectify the problem.

121. During 1991, on behalf of SWIMC and DIMC (depending on the Mark involved), the trademark service provider sent correspondence concerning proposed third-party license agreements, trademark infringement, trademark misuse, disparaging advertising and opposition to third-party application for registration of a Mark.

122. Sherwin-Williams provided SWIMC and DIMC with quarterly invoices that were paid by check. Those quarterly invoices outlined the trademark services provided and the amount of time spent on each matter. In 1991, for services rendered by Sherwin-Williams as trademark service provider, SWIMC paid $12,568.00 and DIMC paid $1,755.00.

123. At the April 30, 1991 meetings of SWIMC's and DIMC's directors, the need for quality control procedures was discussed. At that time, the directors of both companies authorized Dr. Puglisi to obtain the assistance of (1) the trademark service provider for purposes of developing quality control guidelines and (2) the services of Karen Starr, a certified public

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[14] We modified finding of fact "118" to more accurately reflect the record.

accountant affiliated with Wade & Santora, as a quality control service provider with responsibilities for monitoring quality control guidelines through use, among other things, "of a quality control compliance certification to be obtained periodically from licensees of the trademarks and other similar property." Review of the minutes of the July 29, 1991 and October 21, 1991 meetings of SWIMC's and DIMC's directors indicate that the trademark service provider was continuing the process of finalizing the Quality Control Service Provider Agreement ("Quality Control Agreement") that was to be entered into with Wade & Santora.

124. In 1991, neither SWIMC nor DIMC performed any quality control product testing.

125. On August 19, 1992, SWIMC and DIMC each entered into a Quality Control Agreement with Wade & Santora. Ms. Starr executed the agreements on behalf of Wade & Santora. As quality control service provider, Wade & Santora was to monitor the "licensees' performance of their respective obligations with respect to the Quality Control Standards under each of the license agreements" and report the results back to either SWIMC or DIMC depending upon the license involved.

127. As noted above, Sherwin-Williams had one third-party domestic license agreement that it transferred to SWIMC. That license agreement was with Taracorp for the exclusive use of certain "Dutch Boy" Marks on various solder products identified in the license agreement. The license agreement required Taracorp to make quarterly payments based upon the amount of solder sold. If the amount of solder sold was less than a certain amount, then a minimum quarterly payment was due.

128. After the assignment of the license to SWIMC, Taracorp made quarterly royalty payments to SWIMC. During 1991, SWIMC's trademark service provider reviewed Taracorp's compliance with the terms of the licensing agreement.

We modify finding of fact "129" of the Administrative Law Judge's determination to read as follows:

> 129. In 1991, SWIMC and DIMC did not have any third-party licensing marketing programs.[15]

130. During 1991, SWIMC entered into license agreements with third parties. Those licenses are similar to the License Agreements with Sherwin-Williams. The royalty rates determined by AAA were used as a guide in determining third-party royalties.

131. On November 26, 1991, SWIMC granted Startex Chemical, Inc. ("Startex") a non-exclusive, non-transferrable license to use the "So Fast" trademark on solvents, thinners and related products in the continental United States. The license agreement required Startex to "exercise its best efforts to use and exploit the right and license granted herein" and agree "to promote and expand the market" in the United States for the licensed products. Under the license agreement, Startex agreed to pay SWIMC the sum of 25 cents for each gallon of the licensed product manufactured and sold by it. The royalties were payable quarterly within 30 days of the end of each calendar quarter, along with an "accurate itemized certified statement setting forth sales and production reports in sufficient detail" to allow for verification of the royalties determined to be due. There was also a provision for the imposition of interest if a late payment was made.

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[15]We modified finding of fact "129" to more accurately reflect the record.

132. In the summer of 1991, SWIMC received a request from Plastic Specialties and Technologies, Inc. ("Plastic Specialties") for an exclusive license for the use of the "Dutch Boy" trademark on garden hoses. Prior to entering into the license agreement, Dr. Puglisi, as president of SWIMC, requested and received a sample of the garden hose to review.

133. The license agreement between SWIMC and Plastic Specialties was effective as of January 1, 1992 and granted Plastic Specialties an exclusive license to use certain trademarks including Marks and logos representing a Dutch Boy and/or using the words "Dutch Boy" on plastic garden hose in the United States, including its territories and possessions. The license agreement required Plastic Specialties to submit to SWIMC samples from its first production batches of each type of garden hose to be sold under the licensed trademarks. It also required Plastic Specialties to submit to SWIMC for prior approval all labels, advertising and promotional materials related to the sale and marketing of the garden hoses. Under the license agreement, Plastic Specialties agreed to pay a royalty of 5% of the net sales price of all the licensed product sold or otherwise disposed of by it. The royalties were payable quarterly within 30 days of the end of each calendar quarter, along with "an accurate itemized certified statement setting forth in sufficient detail for verification, the basis upon which such payment is determined and made." There also was a provision for the imposition of interest if a late payment was made.

134. During 1991, SWIMC also entered into a third-party license agreement with Minntertainment Company ("Minntertainment"). The license agreement granted Minntertainment the right to use certain trademarks, including the "Cover the Earth" Mark, identified in the license agreement, "solely for the purpose of fulfilling its obligations to Sherwin-Williams" under the terms of the Mall of America Official Sponsor Agreement,

"including, without limitation, promoting Sherwin-Williams as the exclusive paint supplier for the Mall of America." Minntertainment was not required to pay a royalty for its use of the trademarks. Under the license agreement, SWIMC reserved the right to approve all advertising and promotion in connection with the use of the trademarks. Minntertainment was also required to submit a representative sample of its initial proposed use of any of the trademarks for SWIMC's approval.

135. In 1991, DIMC did not enter into any third-party licensing agreements. However, in November 1992, DIMC entered into a licensing agreement with Blue Coral, Inc. ("Blue Coral"). The license agreement granted Blue Coral an exclusive license to use certain "Dupli Color" trademarks in connection with the manufacture, distribution, advertisement and sale of "liquid car wax products containing pigments and colorants designed to match or approximate the existing finish of automobiles" ("authorized products").

136. Under the terms of the licensing agreement, DIMC required Blue Coral to submit samples of all authorized products and samples of the raw materials used in the authorized products. The license agreement also required Blue Coral to submit to DIMC for its prior approval, "all labels, advertising and promotional materials or changes thereto," relating to the sale and marketing of the authorized products. Blue Coral was also required to use its "reasonable best efforts to use and exploit the right and license granted herein" and agreed "to promote and expand the market" in the United States, including its territories and possessions ("the territory"). That license agreement also stated that at DIMC's discretion, the territory "may be expanded to other countries for the sale of the authorized products on a non-exclusive basis."

139. Shortly before SWIMC was formed, Sherwin-Williams commenced an opposition proceeding against National Waterproofing. An opposition proceeding is an administrative proceeding brought to challenge a pending application for use of a trademark. An opposition proceeding was brought to prevent National Waterproofing from registering a trademark that displayed a person, which strongly resembled SWIMC's "Dutch Boy," with his finger in a dike. After the transfer of the "Dutch Boy" mark to SWIMC, it was substituted as the party in that opposition proceeding.

140. On SWIMC's behalf, the trademark service provider, specifically Mr. McDonald, contacted Mr. Bereveskos, an Indiana trademark attorney. Mr. Bereveskos became lead counsel and Mr. McDonald acted as co-counsel in the opposition proceeding.

141. Once SWIMC was substituted, Dr. Puglisi made all significant decisions regarding the opposition proceeding. After an initial settlement offer proposed by SWIMC was rejected, depositions and discovery were conducted. After depositions and discovery, National Waterproofing agreed to abandon its use of SWIMC's Mark and withdraw its application. Dr. Puglisi, as president of SWIMC, executed the settlement documentation. He also paid the legal and consultant fees associated with the opposition proceeding.

Investment Activities

142. SWIMC and DIMC were not merely trademark protection companies. They were also investment companies.

143. Although the SWIMC and DIMC boards of directors established investment guidelines, day-to-day investment decisions were made by Dr. Puglisi.

144. The initial investment guidelines adopted by the directors at SWIMC's and DIMC's initial meetings were modeled after those of Sherwin-Williams. Under those guidelines, SWIMC's and DIMC's excess cash was invested in "Temp Fund" money market accounts to which funds were swept from their respective custodial accounts.

145. Dr. Puglisi presented modifications to the investment guidelines to the directors of SWIMC and DIMC at their respective July 29, 1991 meetings. At those meetings, the directors of each company adopted the modified investment guidelines. The directors of each company directed Dr. Puglisi "to invest on a daily 'sweep' basis cash balances in excess of $2,000 in a Bank of Delaware money market fund selected by" Dr. Puglisi, that had a competitive rate of return. The directors of each company also authorized and directed Dr. Puglisi "to invest significant cash balances as determined by [him], in accordance with the Investment Policy" adopted by the board.

146. As amended pursuant to Dr. Puglisi's recommendations, SWIMC's and DIMC's investment guidelines allow for investment in longer-term and riskier investments than those allowed under Sherwin-Williams' guidelines. All investments, i.e., the purchase of commercial paper or securities, made by SWIMC and DIMC were held in their respective custodial accounts. A review of SWIMC's and DIMC's custodial accounts for 1991 indicates that investments purchased were short-term corporate securities that were held for approximately 7 to 30 days, i.e., until maturity.

147. At its April 30, 1991 meeting, SWIMC's directors considered a loan request from Sherwin-Williams for a 90-day loan proposed to bear interest at the 90-day London Interbank

Offer Rate ("LIBOR") rates.[16] SWIMC's directors tabled discussion until the July 29, 1991 board meeting. At that meeting, they again considered the loan request. At that time, the directors adopted a resolution that authorized Dr. Puglisi to extend a loan to Sherwin-Williams,

> upon receipt of appropriate requests from such payor and all necessary and appropriate loan documentation, in a principal amount not to exceed $7 million, bearing the annual rate of interest of 90-day LIBOR rate plus three-eighths percent (⅜%), for a term of 90 days, with all interest and principal due upon maturity; provided, however, that such loan shall be made subject to adequate cash flow as determined by [him].

148. In October 1991, SWIMC loaned Sherwin-Williams $7 million. The rate SWIMC charged on that loan was 5.812% and was based upon the LIBOR plus three-eighths of 1 percent. The loan made by SWIMC to Sherwin-Williams was for a 90-day term, commencing on October 22, 1991, was memorialized in a written loan agreement, and was repaid early on January 17, 1992, with interest in the amount of $98,328.13.

Success of SWIMC and DIMC

151. For the purposes of this proceeding only, Sherwin-Williams does not contest the Division's contention that it owned or controlled, either directly or indirectly, 80 percent or more of the voting stock of SWIMC and DIMC during the year 1991.

For the purposes of this proceeding only, Sherwin-Williams does not contest the Division's contention that, under New York law, it was conducting a unitary business with SWIMC and DIMC during the year 1991.

152. Petitioner filed a Federal consolidated income tax return for 1991 that included SWIMC and DIMC along with a number of other subsidiaries. On that federal consolidated

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[16] The LIBOR is the benchmark for virtually all short-term basis lending in the world.

return, petitioner reported the following amounts of income and expenses for SWIMC and DIMC.

	SWIMC	DIMC
Interest	$ 184,366.00	$ 32,600.00
Gross Royalties	$41,391,587.00	$6,795,759.00
Total Income	$41,575,953.00	$6,828,359.00
Deductions		
Salaries	17,417.00	17,417.00
Rents	4,125.00	4,125.00
Taxes [Payroll]	1,498.00	1,498.00
Professional Services	17,743.00	12,546.00
Telephone	635.00	635.00
Services and Supplies	7,153.00	5,580.00
Miscellaneous	12,568.00	1,754.00
Total Deductions	61,139.00	43,555.00
Taxable Income	$41,514,814.00	$6,784,804.00

153. In 1991, in addition to the royalties that it received from Sherwin-Williams, SWIMC received approximately $33,332.00 from its third-party licensees. During 1991, DIMC received royalties from Sherwin-Williams and Dupli-Color. It received $761,301.00 in royalties from Dupli-Color.

154. In 1991, there were approximately 1,000 companies in the United States competing in the coatings industry at the national, regional and local levels. Sherwin-Williams competed at all three levels. Its principal national competitors, among others, in the Paint Stores segment were Benjamin Moore & Co., Glidden and PPG Industries, Inc. At the national level, Sherwin-Williams Automotive Division competed with BASF, PPG Industries, Inc. and Du Pont.

155. During 1991, company-operated paint and wall covering stores in 48 states and Canada made up the Paint Stores segment which included the Paint Stores group and a Canadian Division. At that time, the Paint Stores group consisted of the following five geographical divisions: the Mid Central Division which had 524 stores located primarily in the midwestern states; the Eastern Division which had 377 stores located along the upper east coast and in New England; the Southeastern Division which had 481 stores located principally in the lower east and gulf coasts; the South Central Division which had 393 stores located in Texas and the plains; and the Western Division which had 198 stores located primarily in Arizona, Colorado, Nevada, Utah and along the west coast. The Canadian Division included 8 stores in Ontario.

156. A review of the notes to the financial statements attached to petitioner's 1991 Annual Report indicates that inter-divisional "transfers are accounted for at values comparable to normal unaffiliated customer sales."

157. In 1991, Sherwin-Williams celebrated its 125th anniversary of doing business. That same year also marked Sherwin-Williams' 100th year doing business in New York State.

The Audit

158. Petitioner files its New York corporation franchise tax report on a separate basis. On December 14, 1992, the Division commenced a field audit of petitioner's reports for the years 1989 through 1991. Joseph Porempski, an auditor in the Buffalo District Office, conducted that audit.

159. In the field audit narrative, Mr. Porempski stated that Sherwin-Williams' "New York activity includes 68 stores in leased facilities and independent dealers."

160. Mr. Porempski did not testify at the hearing. Rather, his corporation tax audit team leader, Jeffrey Pragel, testified about the conclusions reached in the audit.

161. Based on Mr. Porempski's investigation, the Division concluded that petitioner should be required to file on a combined basis with SWIMC and DIMC. The Division found that two of the three requirements for combination were met. First, Sherwin-Williams owns, directly or through another subsidiary Dupli-Color, 100 percent of the stock of SWIMC and DIMC and therefore satisfies the stock ownership requirement. Second, petitioner and its subsidiaries SWIMC and DIMC are operated as a unitary business. In addition, the Division found that there were substantial intercorporate transactions between both SWIMC and DIMC and petitioner, since almost all of their income was from transactions with petitioner, giving rise to the presumption of distortion.

162. Initially, Mr. Porempski concluded that all of SWIMC's trademarks were licensed to Sherwin-Williams and its subsidiaries, which conclusion is reflected in the narrative section of the field audit report.

163. However, the Division later learned that SWIMC and DIMC had third-party transactions during an informal conference held in the Buffalo District Office on August 23, 1995.

164. Prior to the conference, in April 1994, petitioner supplied the Division with a copy of the AAA appraisal report that determined the royalty rates.

165. After the informal conference, the auditor concluded that a combined report was appropriate after determining that petitioner had not rebutted the presumption of distortion arising from the substantial intercorporate transactions.

166. As an additional ground for requiring the combination in this case, the Division concluded that Sherwin-Williams' assignment of its trademarks to SWIMC and DIMC and their license back of those trademarks to Sherwin-Williams resulted in mismatching of the income and expenses. The Division also concluded that the assignment and license-back transactions did not have economic substance.

167. During the course of the audit, a total of nine consents, extending the period of limitation for assessment of corporation franchise tax for January 1, 1989 through December 31, 1991, were executed by petitioner. Petitioner, by Dennis J. Moir, executed the last consent having the effect of extending the period of limitations for assessment of corporation franchise tax for the period January 1, 1989 through December 31, 1991 to February 15, 1997.[17]

168. Following the August 23, 1995 informal conference, several unsuccessful attempts were made to resolve this case.

169. On December 11, 1996, Mr. Porempski sent a letter to petitioner requesting the opportunity to interview the officers of SWIMC and DIMC.

170. Shortly thereafter, the case was sent to Albany for issuance of a notice of deficiency. The schedules containing the computations of the tax due based on the combination of Sherwin-Williams with SWIMC and DIMC are not part of the record, nor are the computations of additional tax due with respect to the other uncontested audit changes.

171. As noted in Finding of Fact "1," the Division issued the Notice of Deficiency on January 13, 1997.

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[17] Mr. Moir's signature is undated.

172. Mr. Pragel testified that, with the exception of a few small dollar amount cases, forced combination was pursued by the Division in every audit where a corporation paid royalties to an intangible holding company affiliate.

173. In the Case Preparation Worksheet prepared by the auditor prior to the Bureau of Conciliation and Mediation Services conference, Mr. Porempski indicated that documentation was not a factor in the audit.

Petitioner's Expert Witnesses

174. Mr. Spiro Bereveskos, a partner with the Indiana law firm of Woodard, Emhardt, Naughton, Moriarty and McNett, which specializes in intellectual property law, testified as to trademark law and his involvement in SWIMC's litigation against National Waterproofing in the trademark opposition proceeding.

175. Mr. Bereveskos is admitted to practice before the U.S. Patent and Trademark Office and has been involved in hundreds of intellectual property matters. He has lectured and published articles on intellectual property law, is on the advisory board of the professional publication "The IP Litigator" and is the past chairman of the Indianapolis Patent, Trademark and Copyright Association. Mr. Bereveskos was accepted as an expert in trademark and intellectual property law.

176. In the summer of 1991, Mr. Bereveskos was retained by SWIMC to represent it before the U.S. Patent and Trademark Office in the opposition proceeding against National Waterproofing. He had no involvement in the matter prior to SWIMC's ownership of the Marks.

177. During the National Waterproofing proceeding, the documentation showing the transfer of the Marks from Sherwin-Williams to SWIMC and the license of the Marks from

SWIMC to Sherwin-Williams were produced. National Waterproofing never asserted a claim that the assignment of the Marks from Sherwin-Williams to SWIMC or the license from SWIMC to Sherwin-Williams constituted a naked assignment or a naked license. Ultimately, National Waterproofing withdrew its registration application and discontinued its use of the image resembling the "Dutch Boy." SWIMC paid Mr. Bereveskos for his services.

178. Based upon his review of the pertinent documentation, his firsthand knowledge of SWIMC and the testimony at the hearing, Mr. Bereveskos concluded that the assignments and licenses between Sherwin-Williams and SWIMC and DIMC were valid and were not "naked."

179. Mr. Bereveskos also concluded, based upon the testimony he heard and the documentation he had reviewed, that a naked license defense to an action brought by SWIMC or DIMC would not succeed because the licensees were required to maintain certain standards and compliance with those standards was monitored by SWIMC and DIMC.

181. Judgments docketed against SWIMC or DIMC could not be satisfied by attaching Sherwin-Williams' assets. It would be easier to transfer stock in SWIMC or DIMC than to re-register all the Marks that they own.

182. According to Mr. Bereveskos, it is becoming commonplace for corporations to be created to own and license intellectual property because of the benefits that are obtained by having a separate affiliated corporation own and license intellectual property. Benefits include better focus upon management of the intellectual property and insulation of the parent corporation from claims arising from licensing the intellectual property to third parties.

183. Royalties are routinely charged when there are licenses between affiliates.

184. Mr. Bereveskos' firm has recommended the formation of trademark protection companies to its clients. Intellectual property concerns and not potential tax benefits motivated the recommendations. In fact, Mr. Bereveskos' firm does not have any tax attorneys and has no expertise in tax matters.

185. At the hearing, petitioner presented the testimony of Professor Richard D. Pomp, and submitted into evidence a report prepared by Professor Pomp.

186. Professor Pomp holds a J.D. from Harvard Law School and a B.S. from the University of Michigan. He is the Alva P. Loiselle Professor of Law at the University of Connecticut, is an Adjunct Professor of Law at both New York University School of Law and Columbia Law School and is a visiting Professor at Harvard Law School. He has published a casebook (with Oliver Oldman), State and Local Taxation, that is used by law schools, accounting firms and corporations. He was the Director of the New York State Tax Study Commission from 1982 through 1987. Professor Pomp has been retained as a consultant by the Department of Justice, the U.S. Treasury Department, the Internal Revenue Service, the Multistate Tax Commission, and the states of New York, Utah, Louisiana, Illinois, North Dakota, Texas, Montana, Tennessee and Connecticut. Professor Pomp was accepted as an expert on state tax policy.[18]

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[18]We deleted facts numbered "187" - "200" contained in the Administrative Law Judge's determination since those facts were merely legal opinions rendered by Professor Pomp and were improperly included within the findings of fact of this case.

Transfer Pricing Analysis

201. Grant Thornton, one of the largest accounting and management consulting firms in the United States, was retained by Sherwin-Williams to determine whether the three intercompany transactions between Sherwin-Williams and SWIMC and DIMC - - (1) the license of the Marks by SWIMC and DIMC to Sherwin-Williams; (2) the loan made by SWIMC to Sherwin-Williams; and (3) the provision of legal services by Sherwin-Williams to SWIMC and DIMC (together the "Transactions") - - were at arm's-length rates and to prepare a transfer pricing report detailing its findings.

202. Mr. Per Hasenwinkle, a senior manager at Grant Thornton, was responsible for the study and the preparation of the report. He has over 10 years experience with transfer pricing and IRC § 482, and has prepared in excess of 100 transfer pricing studies. Mr. Hasenwinkle was accepted as an expert in transfer pricing, economics and IRC § 482. He testified as to the methodologies used and the conclusions reached in the study. Mr. Hasenwinkle concluded that the Transactions were at arm's-length rates.

203. The study was memorialized in a transfer pricing report that applied the documentation rules under IRC § 6662. In performing the study, Mr. Hasenwinkle and his team applied the standards set forth in IRC § 482 and the regulations adopted by the U.S. Treasury Department in 1994. Although the year in issue here is 1991, Treasury Regulation § 1.482-1(j) provides that the 1994 regulations can be used for all open years.

204. In preparation of the study, Mr. Hasenwinkle and his team reviewed a broad range of quantitative and qualitative internal and external documentation including, among other things,

annual reports, Forms 10-K,[19] product brochures, and intercompany agreements for Sherwin-Williams, SWIMC and DIMC. The Grant Thornton team also reviewed annual reports and Forms 10-K for comparable companies and industry association literature. Numerous discussions were had with Sherwin-Williams' personnel in each of its operating divisions as well as with Dr. Puglisi, SWIMC's and DIMC's president.

205. Mr. Hasenwinkle explained the analysis used in the transfer pricing study. The first step taken was the performance of a functional analysis, one of the primary tools used by economists in analyzing a company. This analysis looks to the functions a company performs in bringing a product to the market. A functional analysis is used to develop a profile that can be used to identify companies that are comparable to the company that is being analyzed. Then a risk analysis is performed to determine the risks assumed by the company in performing its functions.

Next, the tested party is chosen by determining which of the related companies that is involved in the intercompany transactions at issue is the easiest to analyze. Under the IRC § 482 regulations, the party to evaluate in order to determine whether intercompany prices are at arm's length is generally the party for which data: (1) are the most complete, (2) are the most reliable and can be easily verified, and (3) require the fewest adjustments. In most cases, the party to an intercompany transaction to be evaluated is the simplest of the entities involved (i.e., performs the least complex functions), and is the one that does not own valuable, non-routine intangible property or other unique assets that distinguish it from potentially comparable uncontrolled

[19] A Form 10-K is an annual report required to be filed with the Securities and Exchange Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934.

companies. After the tested party is chosen, a decision is then made as to which method for analyzing the related transactions is the best.

206. The selection of the best method depends on a number of factors such as: the availability of complete and reliable data; the degree of comparability between controlled and uncontrolled companies (or transactions); and the number, magnitude and accuracy of adjustments necessary to apply the method. Four transfer pricing methods are available for evaluating intercompany transfers of intangible property: the Comparable Uncontrolled Transaction method, the Comparable Profits Method, the Profit Split Method and "Unspecified" methods.

The Comparable Uncontrolled Transaction method ("CUT") evaluates whether the amount charged for a controlled transfer of intangible property is arm's length by reference to the amount charged in a comparable uncontrolled transaction (Treas Reg § 1.482-4[c][1]). The Comparable Profits Method ("CPM") evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators or "PLIs") derived from uncontrolled parties that engage in similar business activities under similar circumstances (Treas Reg § 1.482-5[a]). The Profit Split Method ("PSM") evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled party's contribution to the combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled parties for which data is available that includes the controlled transactions (relevant business activity) (Treas Reg § 1.482-6[a]). The "Unspecified" method must be applied in accordance with the provisions of Treas Reg § 1.482-1 and should take into account the general principle that uncontrolled parties evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it (Treas Reg § 1.482-4[d][1]).

207. Comparable companies are then selected based upon whether they perform similar functions and assume similar risks to those of the tested party. The profitability of the comparable companies is then evaluated and adjustments are made to account for differences between the tested party and the comparables.

Analysis of Royalty Rates

208. In performing the transfer pricing study regarding the royalties paid by Sherwin-Williams to SWIMC and DIMC, the functional analysis separately examined each of Sherwin-Williams' operating divisions, i.e., Automotive, Consumer,[20] Specialty, Paint Stores[21] and Transportation, and SWIMC and DIMC, to determine the functions each performed and the risks each assumed. The operating divisions were examined rather than Sherwin-Williams as a single entity because the examination of the most narrowly defined business segment within the company increases the reliability and accuracy of the study. The risks identified by the IRC § 482 regulations (e.g., market risks, management risks and financial risks) were then analyzed for Sherwin-Williams' operating divisions and for SWIMC and DIMC.

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[20] The operations of the Chemical Coatings Division, which was dissolved during the 1991 fiscal year, were included in the Consumer Division.

[21] The operations of International (Domestic) and Canadian Paint Stores divisions were included in the Paint Stores Division.

We modify finding of fact "209" of the Administrative Law Judge's determination to read as follows:

> 209. Mr. Hasenwinkle noted that, under an IRC § 482 analysis, if a company had no economic substance it would perform no functions and would assume no risks. Since, in his view, SWIMC and DIMC performed several functions (e.g., protecting and managing their respective Marks and investing their funds), and assumed risks (e.g., market and financial risks) Mr. Hasenwinkle concluded that each corporation had economic substance.[22]

210. Based on the functional analysis, Sherwin-Williams' operating divisions were determined to be the tested parties.

211. The Grant Thornton report set forth the royalty payments received by SWIMC and DIMC in table form, as follows:

Sherwin-Williams Divisions	SWIMC Royalty Income	DIMC Royalty Income
Automotive	$11,170,864.00	-0-
Consumer	4,710,705.00	-0-
Specialty	215,063.00	4,643,516.00
Stores	25,261,622.00	1,390,943.00
Transportation	-0-	-0-
Total	$41,358,254.00	$6,034,459.00

212. After analyzing the methods available under the IRC § 482 regulations for testing whether rates for use of intangible property are at arm's length, Mr. Hasenwinkle determined that the CPM was the best method for analyzing the arm's-length nature of the royalties being paid by Sherwin-Williams for its use of SWIMC's and DIMC's Marks. The CUT method was

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[22] We modified finding of fact "209" to more accurately reflect the record.

not chosen because neither internal nor external comparable licensing transactions could be identified. Both the comparable and residual PSMs were considered and rejected as the best method for evaluating SWIMC's and DIMC's intercompany transfer prices with Sherwin-Williams. Grant Thornton was unable to identify any unrelated parties satisfying the requirements necessary to apply the comparable PSM. After analyzing Sherwin-Williams' and SWIMC's and DIMC's operations, Grant Thornton determined that SWIMC and DIMC were the only parties that owned significant intangible assets related to the intercompany transactions being evaluated to warrant the use of the residual PSM.

213. Next, a search for independent companies that performed manufacturing and distribution functions similar to those performed by Sherwin-Williams' operating divisions was conducted. The goal of the search was to identify independent comparable companies that could be used in profitability analyses to determine the arm's-length level of profit that Sherwin-Williams' operating divisions should generate on their manufacturing, distribution and transportation activities. Two financial databases, the Disclosure Compact D SEC and Standard & Poor's Compustat (North America), were searched using the Standard Industrial Classification ("SIC") codes applicable to Sherwin-Williams' divisions. The SIC codes are the way the United States government effectively sectors the United States economy into different industries. As a second step, the list of potentially comparable companies derived in this manner was then winnowed by eliminating those companies for which financial data for the years 1989 through 1991 was unavailable. That screening criteria was required to: eliminate startup and inactive companies; to provide sufficient historical data to even out one-year aberrations in financial results; and to normalize the effects of product or business cycles. The third step was to examine

the companies to determine to what extent, if any, they engaged in activities generally associated with the development of intangible assets, such as research and development ("R&D") or marketing and promotional activities. Companies that were determined to commit significant resources to those functional areas were eliminated from the sample, because capital invested in R&D and promotional activities is inherently more risky than capital invested in basic manufacturing activities, due to the uncertainty of the economic outcome from those activities. The level of R&D and marketing expenditures were evaluated according to three factors: (1) excessive market value relative to book value, (2) extraordinary R&D relative to sales, and (3) material importance placed on trademarks in the comparable company's SEC Form 10-K report. A company that failed two of these three criteria was eliminated from the sample. Under this step, companies were excluded, such as Benjamin Moore, that owned significant intangibles and whose expected profits would be greater because of the inclusion of those intangibles. Lastly, a functional and product comparability analysis was then performed. Companies that (1) were not manufacturers, (2) did not sell to the same market level, (3) did not utilize a similar sales channel, or (4) did not produce a similar product were eliminated. Companies were also evaluated on the basis of other factors that would distort the returns represented on the company's financial reports. Those additional factors included: (1) the occurrence of a merger, acquisition, or dissolution, (2) bankruptcy proceedings, or (3) viability as a going concern or companies with material financial or legal liabilities. When Sherwin-Williams appeared in a comparable company search result, it was not included in the sample. The results of both the functional analysis and the application of the above-described search process for each operating division are set forth below.

214. The Automotive Division was determined to be primarily engaged in the manufacture of after-market automotive finishes that are sold to vehicle repair shops, production shops, and distributors/jobbers. It also produces exterior finishes for tractor trailers and interior finishes for automotive components that are sold to heavy duty fleet and storage equipment OEMs. It was also determined that the two principal product lines are sold directly to four target consumers (i.e., vehicle repair shops, distributors/jobbers, production shops and OEMs) by approximately 450 sales employees.

We modify finding of fact "215" of the Administrative Law Judge's determination to read as follows:

> 215. Although, in 1991, the Automotive Division's products were also marketed through 154 "company-operated" automotive branches that generated approximately 50% of that division's sales, it is not mentioned in the functional analysis since Mr. Hasenwinkle was unaware that the Automotive Division had automotive branches.[23]
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216. SIC codes 2851(for companies that manufacture paint, varnishes, lacquers, enamels and allied products) and 2842 (for companies that manufacture specialty cleaning, polishing and sanitation preparation type products) were used for the Automotive Division search that produced a total of 36 companies. The financial data screen reduced the initial sample by 15, leaving 21 companies for further research. The intangible assets screen reduced the set by 2 companies, while the final functional and product evaluation eliminated 15 additional companies, leaving a final set of 4 companies consisting of Grow Group, Inc., Lilly Industries, Inc., PPG Industries Inc., and RPM Inc.

[23]We modified finding of fact "215" to more succinctly set forth the fact that Mr. Hasenwinkle did not know about the automotive branches when he prepared his report.

217. The Consumer Division was determined to manufacture interior and exterior architectural coatings which are sold directly to retailers for resale to the do-it-yourselfer market. It also produces marine and industrial coatings. Each of its four primary product groups, “Dutch Boy,” “Martin-Senour,” Private Label, and National Accounts, target a different segment of the retail market. “Dutch Boy” paints are sold at wholesale to hardware stores and homebuilders and are also sold through K-Mart outlets bearing a joint K-Mart/Dutch Boy logo. “Dutch Boy” sales to K-Mart are coordinated through the National Accounts Group. “Martin-Senour” products are sold exclusively to independent paint dealers. All private-label brands are sold under marks designated by the retailers as their in-house brand. National Accounts sells “Kem-Tone” products to national discount chains and other paint products private-labeled on behalf of the purchaser, usually a mass merchandiser. The end-user of all of the Consumer Division’s products is the do-it-yourselfer or small contractor who is price conscious.

218. For the Consumer Division, SIC code 2851 (for companies that manufacture paint, varnishes, lacquers, enamels and sealers) was chosen. One additional company, with a 2899 primary SIC code (Compact D SEC), which had been rejected from the search conducted for the Specialty Division, was added to the initial search. The initial search produced a total of 25 companies. The financial data screen reduced the sample by 12, leaving 13 companies for further scrutiny. The intangible assets screen reduced the set by one company, while the final functional and product evaluation eliminated five companies, leaving a final set of eight companies consisting of Ferro Corp., Grow Group, Inc., Guardsman Products Inc., Lilly Industries Inc., PPG Industries, Inc., Pratt & Lambert Inc., RPM, Inc. and the Valspar Corp.

219. The Specialty Division was determined to manufacture and distribute paint applicators and aerosol spray paints for sale to mass merchandisers and independent paint and hardware stores. It also manufactures various lubricants and cleaners for sale to distributors and commercial users. Five key business segments are served by the Specialty Division's products: (1) general retail, (2) automotive, (3) industrial, (4) custom, and (5) specialty. The general retail, automotive and specialty segments sell directly to hardware stores, national retail chains and mass merchandisers for resale to the do-it-yourself retail market. The industrial and custom segments sell to the industrial or maintenance end-user.

220. For the Specialty Division, SIC codes 2851 (for companies that produce paints, varnishes, lacquers, enamels, and allied products), 2842 (for companies that manufacture specialty cleaning, polishing and sanitation products) and 2899 (for companies that produce miscellaneous application chemicals) were chosen. The search produced a total of 61 companies for further research. The financial data screen reduced the sample by 29, leaving 32 companies for further scrutiny. The intangible assets screen reduced the set by 3 companies, while the functional and product screen eliminated 24 companies, leaving a final group of 5 companies consisting of Arrow Magnolia Intl. Inc., Grow Group Inc., Guardsman Products, Inc., Ocean Bio Chem Inc. and Specialty Chemical Resources Inc.

221. The record includes photocopies of portions of the Forms 10-K and annual reports for a number of the companies chosen by Grant Thornton for the five operating divisions.[24]

222. According to its Annual Report, PPG Industries Inc. ("PPG") is comprised of three basic business segments: glass, coatings and resins, and chemicals. It is one of the major

[24] Some of the photocopies are barely legible.

producers of flat glass, fabricated glass and continuous strand fiber glass in the world. In 1991, approximately 39% of its net sales came from the production of glass. PPG is a major producer of protective and decorative coatings. According to PPG's 1991 Annual Report, it is the "world's leading supplier of automotive and industrial finishes" and a "major supplier of architectural finishes." Sherwin-Williams is identified, in that Annual Report, as one of PPG's major competitors in the supply of coating products for automotive manufacturing and repair; commercial and residential construction and maintenance; and factory finishing of various industrial, construction and consumer products. In 1991, approximately 39% of its total net sales came from the production of coatings and resins.

The industrial portion of its coatings business involves the supply of protective and decorative finishes for automobiles, appliances, industrial equipment, and containers; factory finished aluminum extrusions and coils for architectural uses; and other industrial and consumer products. In addition to supplying finishes to the automobile OEM, PPG supplies automotive refinishes to the aftermarket which are primarily sold through distributors.

PPG's architectural finishes business consists primarily of coatings used by painting and maintenance contractors and by consumers for decoration and maintenance. Its products are sold through independent distributors, paint dealers, mass merchandisers and home centers.

223. Lilly Industries, Inc. ("Lilly) is principally engaged in the business of manufacturing and selling industrial coatings (including enamels, varnishes, lacquers, gelcoats, silver solutions and similar coatings) to other manufacturing companies. Lilly's products include liquid and powder coatings used by a variety of manufacturers to coat wood, plastics and metal substrates. It manufactures, among other things, wood coatings for furniture, flooring, kitchen cabinets and

paneling; coil coatings for appliances, aluminum residential siding and components, automotive parts, doors, windows and metal buildings; general metal coatings for a broad range of metal products, including aluminum extrusions, appliances, caskets, office furniture, and truck trailers; automotive refinishes and trade sales coatings. According to the Annual Report, Lilly's automotive refinishes are "distributed mainly to repair shops and fleet users" and its trade sales coatings are "sold primarily to professional contractors and homeowners."

224. According to its Form 10-K and Annual Report, Grow Group, Inc. ("Grow Group") "is one of America's foremost producers of specialty chemical coatings and paints, pool and spa products and detergents, maintenance and cleaning products for household, professional and industrial use throughout the world." Grow Group consists of two operating groups: coatings and chemicals and consumer and professional products. In 1991, the coatings and chemicals group accounted for 69% of Grow Group's total net sales, with the remaining 31% attributable to the consumer and professional products group.

In its coatings and chemical group, Grow Group produces architectural coatings, automotive and industrial products, and maintenance and marine coatings. Grow Group produces and markets protective and decorative water and solvent thinnable trade or general purpose paints and coatings (enamels, varnishes and stains) as well as interior and exterior waterproof coatings, for use by painting contractors, industrial and commercial users and the general public for the interior and exterior of homes, buildings and other structures. It also sells a variety of brushes, rollers, wallpaper and other decorating and painting equipment items purchased from others. The architectural coatings are marketed through more than 1,000 independent retail dealers and approximately 100 "company-operated" outlets. Its trade paint customers are primarily dealers and paint contractors with additional sales to retail consumers and industrial, institutional, commercial maintenance and private label accounts.

Grow Group's automotive products include solvents, thinners, paint strippers, adhesives and sealants used primarily by automotive manufacturers, their suppliers of component parts, the automotive after-market and "to a lesser extent, non-automotive customers." The automotive products are marketed primarily by Grow Group's salaried salesmen. Grow Group also produces and sells heavy duty, high performance coatings for industrial maintenance and marine applications.

Grow Group's consumer and professional products group manufactures swimming pool chemicals and a line of household laundry cleaning and industrial maintenance products. The household cleaning and professional products that the consumer and professional products group produces include soaps, detergents, floor finishes, furniture polishes, waxes and other chemicals and products for cleaning, waxing, buffing, stripping and maintaining clothing, walls, windows, floors and furniture. These products are marketed by hardware and drug stores, supermarkets, mass merchandisers, specialty home care centers, convenience stores and warehouse/club outlets. The consumer and professional products group also produces and sells a wide line of paint products and adhesives in aerosol spray dispensers (aerosol products).

225. According to its Annual Report, Ferro Corp. ("Ferro") manufactures three major specialty product lines: coatings, colors and ceramics; plastics; and chemicals. Ferro's specialty materials are used by manufacturers in a broad range of applications. The end markets that Ferro serves include, among others, building and renovation, major appliances, household furnishings, industrial products, transportation, packaging and leisure products. In 1991, sales of coatings,

colors and ceramics accounted for 55% of Ferro’s total sales. Ferro’s specialty plastics segment manufactures color concentrates, gelcoats, paste colors, liquid and dry colors; filled and reinforced plastics and engineering thermoplastics. Its specialty chemicals segment manufactures polymer additives, fuel additives and friction modifiers, industrial chemicals, metalworking additives and flame retardants.

226. Petitioner’s Paint Stores Division was determined to sell architectural, marine and industrial coatings through Sherwin-Williams paint stores. The paint stores are the exclusive seller of the “Sherwin-Williams” brand of interior and exterior house paint. The paint is sold at retail to do-it-yourselfers and wholesale to painting professionals, contractors and paint specifiers.[25] Industrial coatings, marine paints and specially-developed coatings resistant to harsh chemicals or toxic environments, are sold directly to industrial maintenance contractors. Specialty chemical coatings for the non-automotive original equipment manufacturer (“OEM”) market are also sold by the division directly to manufacturers. OEM products include, among other things, metal office furniture, aluminum siding and computer housings.

We modify finding of fact “227” of the Administrative Law Judge’s determination to read as follows:

> 227. The search for comparable companies was slightly different for the operating divisions that performed distribution functions, specifically the Paint Stores Division and the Transportation Division, rather than manufacturing functions. Based on conversations with Sherwin-Williams personnel, Grant Thornton determined that the wholesale market accounted for approximately 80% of the Paint Stores Division’s sales and the retail market accounted for 20% of its sales. Since the Paint Stores Division performed two functions, a wholesale distribution

[25] A paint specifier is an owner, architect, or other person who indicates which paint should be used by the painter for a particular project or series of projects.

> function and a retail distribution function, which sold to different market levels, two searches were conducted. To identify wholesale distribution companies that distribute paint and related equipment, the search focused on companies that were categorized under the primary SIC codes for various types of distributors of goods. The SIC code search identified 168 companies. An initial screening out of companies that did not have adequate financial data and developed or owned intangible assets eliminated 91 companies, leaving 77 companies for further consideration. To identify retail distribution companies that distribute paint and related equipment, the following SIC codes were used: 5211 (for lumber and other building materials dealers); 5251 (for hardware stores); 5261 (for retail nurseries, lawn and garden supply stores); 5713 (for floor covering stores) and 5714 (for drapery, curtain and upholstery stores). The initial SIC code search identified 56 companies. The initial screening, for inadequate financial data and the development or ownership of intangible assets, eliminated 30 companies, leaving 26 companies for further review.[26]

228. The final step in the search for comparable wholesale and retail distribution companies eliminated those companies that did not distribute through sales channels and at market levels similar to those of the Paint Stores Division. In addition, companies that owned valuable intangible property, such as patents, trademarks or trade names, deemed critical to their business enterprise were disqualified from inclusion in the final set of comparable companies. This final functional and product comparability examination rejected 73 additional wholesale distribution companies and 20 additional retail distribution companies, leaving a final set of 4 wholesale distributors and 6 retail distributors. The wholesale distribution comparables were: Hughes Supply Inc., Noland Co., Payless Cashways Inc., and Strober Organization Inc. The retail distribution comparables were: Color Tile Inc., Grossman's Inc., Hechinger Co., Lowe's Cos. Inc., NHD Stores Inc., and Wolohan Lumber Co.

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[26]We modified finding of fact "227" to more accurately reflect the record.

229. According to the Form 10-K and the Annual Report for Hughes Supply Inc. ("Hughes") for the fiscal year ended January 31, 1992, it is primarily engaged in the wholesale distribution of a broad range of materials, equipment and supplies to the construction industry and the mechanical and electrical trades. Its customers are subcontractors, electric utilities, municipalities and industrial accounts. Hughes distributes more than 85,000 different products through 117 wholesale outlets in Florida, Georgia, North Carolina, South Carolina, Tennessee, Kentucky, Mississippi, Maryland and Alabama. According to the Form 10-K, on the basis of its total sales, Hughes is the largest wholesale distributor of its range of products in the Southeast. For the fiscal year ended January 31, 1992, net sales were $481,001,000.00.

230. According to the Annual Report for the Noland Company ("Noland") for the fiscal year ended December 31, 1991, it is one of the nation's leading independent wholesalers with 92 branches in the following 13 southern states: Alabama, Arkansas, Florida, Georgia, Kentucky, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Texas, Virginia and West Virginia. Noland sells a wide variety of products to nearly 34,000 customers. For the fiscal year ended December 31, 1991, Noland's net sales were $384,535,000.00.

231. According to the Form 10-K for Payless Cashways, Inc. ("Payless") for the fiscal year ended November 30, 1991, it operated 195 retail stores in the following 26 states: Arizona, Arkansas, California, Colorado, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee and Texas. Each of Payless's retail stores is designed as a one-stop shopping center to provide greater convenience for the serious do-it-yourselfer and the professional customer. Payless sells

a broad range of building material products. For the fiscal year ended November 30, 1991, Payless's net sales were $2,387,235,000.00.

232. According to the Form 10-K for the Strober Organization Inc. ("Strober") for the fiscal year ended December 31, 1991, it is a supplier of building materials that served professional contractors out of ten building supply centers, two Kitchen and Bath centers and three Peachtree Planning centers, with a total of approximately 452,700 square feet of covered space, in New York, New Jersey, Connecticut and Pennsylvania. For the fiscal year ended December 31, 1991, Strober's net sales were $90,150,000.00.

233. According to the Form 10-K for Color Tile Inc. ("Color Tile") for the fiscal year ended December 29, 1991, it operates specialty retail stores serving do-it-yourself, buy-it-yourself, and commercial customers in 48 states in the United States and in 7 provinces in Canada. In 1991, Color Tile had a total of 770 stores and 13 franchised store locations. In the United States, 725 stores were operated under the name "Color Tile" and 6 stores were operated under the name "Peerless." In Canada, 39 stores were operated under the name "Factory Carpet." The products sold through Color Tile's stores include hard surface tiles, such as ceramic, mosaic and quarry tile, wood flooring, resilient flooring, carpeting, wall coverings, window treatments, installation materials and tools, and related installation services. For the fiscal year ended December 29, 1991, Color Tile's net sales were $544,315,000.00.

234. Grossman's Inc. ("Grossman's") is a retailer of lumber, building materials, and other home improvement products. In 1991, it operated 139 stores, in the six New England states, New York, New Jersey, Pennsylvania and California. Grossman's stores are one-stop shopping centers designed to supply customers with materials and tools necessary to carry out home

improvement projects. According to the Form 10-K, historically, Grossman's has recorded its highest sales level in the second and third quarters of the year. In 1991, Grossman's net sales were $806,636,000.00.

235. According to the Annual Report for Hechinger Company ("Hechinger") for the fiscal year ended February 2, 1991, it is a leading specialty retailer providing products and services for the care, repair, remodeling and maintenance of the home and garden. At that time, it served the home improvement industry through three separate operations: Hechinger, whose 84 stores served do-it-yourselfers from the Carolinas to Connecticut and as far west as Ohio; Home Quarters Warehouse ("HQ"), with 28 stores up and down the east coast; and Triangle Building Centers, with 6 stores that covered mid-eastern Pennsylvania. Hechinger stores offer expert advice and a full range of building material and home improvement merchandise to customers. HQ stores follow the warehouse format and bring a "powerful assortment" of building supply products to the do-it-yourself and professional home repair and remodeling customers. For the fiscal year ended February 1, 1992, Hechinger's net sales were $1,607,727,000.00.

236. According to the Annual Report for Lowe's Cos. Inc. ("Lowe's) for the fiscal year ended January 31, 1991, it is a specialty retailer in the do-it-yourself home center business, the consumer durables business and the building contractor business. In 1990, Lowe's had 309 stores located principally in the South Atlantic and South Central regions of the United States. At that time, its stores served customers in the following 20 states: Alabama, Arkansas, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maryland, Mississippi, Missouri, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, and West Virginia. Lowe's net sales for the fiscal year ended January 31, 1991 were

$2,833,108,000.00. The Annual Report highlights the fact that in Fortune magazine's latest listing of America's top retailers, Lowe's ranked 43rd in sales; 27th in profits and 15th in total return to investors. The Annual Report also identifies that in Builders Supply Home Center's 1990 annual list of the top ten building supply/home center companies, Lowe's ranked number 2, Payless Cashways, Inc. ranked number 3, Hechinger Co. ranked number 5, and Grossman's ranked number 8.

237. According to the Form 10-K for NHD Stores, Inc. ("NHD") for the fiscal year ended January 25, 1992, it is engaged in the retail sale of hard goods items through individual hardware stores. In 1991, NHD operated 35 "NHD Super Hardware Stores" in five New England states. According to the Form 10-K, NHD's total sales for the fiscal year ended January 25, 1992, increased by 1.7% to $56,876,218.00.

238. According to the Form 10-K and the Annual report for Wolohan Lumber Co. ("Wolohan Lumber") for the fiscal year ended December 31, 1991, it is engaged in the retail sale of a full line of lumber and building materials and related items through a chain of 51 building supply stores located in the Midwest, specifically, Illinois, Indiana, Kentucky, Michigan, Missouri, Ohio and Wisconsin. Wolohan provides service to both "consumer/do-it-yourself" and professional contractor customers. According to the Form 10-K, Wolohan's business is subject to seasonal influences. The second and third quarters are generally the periods of highest sales volumes while the first quarter is usually the period of lowest sales volume. For the fiscal year ended December 31, 1991, Wolohan's sales increased 3% to a record $303,715,000.00.

239. The Transportation Division was determined to distribute and transport finished goods for the other operating divisions of Sherwin-Williams. The division's fleet of 350

Sherwin-Williams owned, self-insured trucks and trailers is licensed as a common carrier and engages in limited back hauling that represents 10% of fleet revenue. The remaining 90% of fleet revenue is generated from intercompany receipts. The fleet is allocated, according to distribution volume, among six regionally-located, domestic distribution service centers.

240. To identify independent trucking companies that transport general, non-hazardous, and non-perishable commodities, the search focused on companies that were categorized under the primary SIC codes 4212 (for local trucking services without storage); 4213 (for trucking services, except local); 4214 (for local trucking services with storage); and 4215 (for courier services, except by air). The SIC code search identified 83 companies. After screening out companies that: (1) did not have adequate financial data, (2) developed or owned intangible assets, and (3) did not perform distribution functions or transport products similar to those of the Transportation Division, a final set of 18 transportation service companies was left. The transportation service comparables consisted of: American Freightways, Arnold Industries Inc., Builders Transport Inc., Cannon Express Inc., Central Freight Lines Inc., Chemical Leaman Corp., General Parcel Service Inc., Intrenet Inc., J B Hunt Transport Service Inc., M S Carriers Inc., NFC Plc, Old Dominion Freight Line Inc., OTR Express Inc., P A M Transportation Services Inc., Preston Corp., Swift Transportation Co. Inc., Transcon Inc., and Transit Group Inc.

We modify finding of fact "241" of the Administrative Law Judge's determination to read as follows:

> 241. Based on his experience in performing over 100 transfer pricing studies, Mr. Hasenwinkle concluded that the comparables identified for each of Sherwin-Williams' divisions were excellent comparables that were very strong from both a

> functional and industry perspective. Mr. Hasenwinkle stated in his report that the comparables chosen were "reliable proxies for evaluating the arm's-length profits of Sherwin-Williams' operating Divisions" (Exhibit "16," p. 42).[27]

242. Under the CPM, the arm's-length result is determined by the amount of operating profit that the tested party would have earned on the controlled transaction if its PLIs were equal to that of an uncontrolled comparable company. An arm's-length level of profit is calculated by applying the PLI of the comparable independent company to the financial data related to the controlled transactions. PLIs are ratios that measure the relationship between profits and costs incurred or resources employed. The IRC § 482 regulations provide that a variety of PLIs can be used in any given analysis. The choice of PLI depends upon a number of factors, including the activities of the tested party, the reliability of the data of the comparable uncontrolled companies, and the extent to which the indicator will produce a reliable measure of an arm's-length result. These PLIs include the rate of return on capital employed and various financial ratios. The regulations also recommend that the PLIs should be derived from a period that encompasses at least the year under review and the two preceding years.

243. The rate of return on capital employed is defined as the ratio of operating profits to operating assets ("ROA"). The reliability of this PLI increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable companies. In addition, the reliability of this PLI depends upon the extent to which the composition of the tested party's assets is similar to those of the uncontrolled comparables.

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[27] We modified finding of fact "241" to more accurately reflect the record.

Financial ratios measure the relationship between profit and costs or revenues, and are generally more sensitive to functional differences than the ROA. Therefore, closer functional comparability is required when applying a financial ratio PLI. Financial ratios that may be employed include, among others, ratio of operating profit to sales and ratio of gross profit to operating expenses.

244. Each comparable company's profitability for 1989, 1990 and 1991 as well as the three-year average was calculated. Grant Thornton also calculated the profitability of each of the five operating divisions for the same periods. The appendices of the transfer pricing report contain portions of the statements of operations for each comparable company and the five operating divisions.

We modify finding of fact "245" of the Administrative Law Judge's determination to read as follows:

> 245. In order to calculate the net-of-royalty operating profit for each of the five operating divisions as if it was a stand-alone entity, Grant Thornton had to allocate to each division a portion of Sherwin-Williams' Corporate Division's ("Corporate") sales and expenses. Corporate overhead allocation tables for each operating division are included in the appendices. However, the financial records for each of the Divisions were not attached to the report.[28]

246. To allocate Corporate's sales to each operating division, Grant Thornton used the percentage of total net sales ("sales ratio") generated by that operating division. For purposes of calculating the sales ratio, Grant Thornton determined the 1991 total net sales for the five operating divisions to be $3,043,194,444.00. Net sales for the Automotive Division were determined to be $313,651,417.00 in 1991. Net sales for the Consumer Division (that included

[28]We modified finding of fact "245" to more accurately reflect the record.

the operations of the Chemical Coatings Division) were determined to be $932,936,228.00 in 1991. Net sales for the Specialty Division were determined to be $251,731,384.00 in 1991. Net sales for the Paint Stores Division (that included the operations of the International [Domestic] and the Canadian Paint Stores divisions) were determined to be $1,503,000,069.00 in 1991. Net sales for the Transportation Division were determined to be $41,875,346.00 in 1991. The net sales for each of the operating divisions included inter-divisional sales.

247. To allocate Corporate's cost of sales to each operating division, Grant Thornton used the percentage of total cost of sales ("cost of sales ratio") generated by each operating division. For 1991, Grant Thornton determined the total cost of sales for the five operating divisions to be $2,051,668,923.00 (Automotive Division's cost of sales of $176,909,787.00 plus Consumer Division's cost of sales of $764,481,109.00 plus Specialty Division's cost of sales of $176,782,375.00 plus Paint Stores Division's cost of sales of $897,686,681.00 plus Transportation Division's cost of sales of $35,808,971.00).

248. The sales ratio was used to allocate Corporate's general and administration expenses to each of the operating divisions. Marketing expenses were allocated to each operating division based on Sherwin-Williams' records. Grant Thornton also had to allocate the depreciation expense because most of the assets of Sherwin-Williams are located in the Corporate Division. Grant Thornton used the sales ratio to allocate depreciation to each operating division.

249. To establish comparability with operating profits for 1989 and 1990, Grant Thornton computed Sherwin-Williams' net-of-royalty operating profit for each operating division by applying the same royalty rate to sales percentage in those years as each of Sherwin-Williams' operating divisions paid in 1991. The 1991 royalty rate to sales percentage for each operating

division was determined to be the following: Automotive Division 3.56% (SWIMC); Consumer Division 0.50% (SWIMC); Specialty Division a total of 1.93% (consisting of 0.09% for SWIMC and 1.84% for DIMC); Paint Stores Division a total of 1.77% (consisting of 1.68% for SWIMC and 0.09% for DIMC); and Transportation Division 0.00%.

250. Since the license agreements went into effect in February 1991, this approach only included the royalties that Sherwin-Williams paid on February to December sales. To adjust the royalty rate in those years to what it would be on a full-year basis, assuming that sales are spread evenly throughout the year, it is necessary to increase each royalty rate by 9.09% (12/11-1 = 9.09%). The annualized royalty rates by division would be: Automotive Division 3.88% (an increase of 0.32%); Consumer Division 0.55% (an increase of 0.05%); Specialty Division 2.10% (an increase of 0.17%) and Paint Stores Division 1.93% (an increase of 0.16%).

251. To determine the profitability of the comparable companies, Grant Thornton calculated the fully-loaded cost plus ratio and the operating margins generated by the comparable companies. The PLI used for the manufacturing and transportation comparables was the fully-loaded cost plus ratio. The fully-loaded cost plus ratio is the ratio of operating profit to total costs (cost of goods sold plus operating expenses). In the transfer pricing report, Grant Thornton noted that the fully-loaded cost plus ratio is not specifically mentioned in the IRC § 482 regulations, but is frequently used by practitioners as a reliable gauge to evaluate the routine profit levels of manufacturing and service companies. For the Paint Stores Division's comparables, Grant Thornton used the ratio of operating profit to sales.

252. Grant Thornton used the interquartile range to increase the reliability of the profitability analysis.[29] Operating profits falling within the interquartile range are deemed to be at arm's length (Treas Reg § 1.482-1[e][2][iii][B]). In recognition of the fact that the manufacturing and distribution companies identified did not conduct their business operations in exactly the same manner as the five operating divisions, Grant Thornton made adjustments for terms of sale (i.e., accounts receivable) and purchase (i.e., accounts payable) and inventory-holding (i.e., inventory) levels. A summary of the comparable financial results that Grant Thornton reached for each of the operating divisions, on a post-royalty income basis, relative to the comparable companies follows.

253. The Automotive Division was determined to have generated three-year average fully-loaded cost plus markups of 12.28%. On a three-year average basis, the Automotive Division generated profits that fell within the three-year average interquartile range for comparable manufacturing companies, that generated adjusted fully-loaded cost plus markups between 7.15% and 14.05%. For 1991, the Automotive Division's fully-loaded cost plus markup was determined to be 11.17%. That level of profit fell within the 1991 interquartile range for comparable companies that generated adjusted fully-loaded cost plus markups between 5.70% and 12.19%.

254. The Consumer Division was determined to have generated three-year average fully-loaded cost plus markups of 5.36%. On a three-year average basis, the Consumer Division generated profits that fell within the three-year interquartile range for comparable manufacturing companies that generated adjusted fully-loaded cost plus markups between 3.70% and 9.17%.

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[29] The interquartile range is defined to encompass results between the 25th percentile and the 75th percentile of the observations derived from uncontrolled comparables (Treas Reg § 1.482-1[e][2][iii][B]).

For 1991, the Consumer Division's fully-loaded cost plus markup was determined to be 4.38%. That level of profit fell within the 1991 interquartile range for comparable companies that generated adjusted fully-loaded cost plus markups between 2.29% and 8.66%.

255. The Specialty Division was determined to have generated three-year average fully-loaded cost plus markups of 7.31%. On a three-year average basis, the Specialty Division generated profits that fell within the three-year interquartile range for comparable manufacturing companies that generated adjusted fully-loaded cost plus markups between 4.80% and 9.07%. For 1991, the Specialty Division's fully-loaded cost plus markup was determined to be 7.92%. That level of profit fell within the 1991 interquartile range for comparable companies that generated adjusted fully-loaded cost plus markups between 2.92% and 13.19%.

256. The Paint Stores Division comparability analysis was done in two steps. First, Grant Thornton used the adjusted operating profits to sales ratio to calculate the profitability of the comparable wholesale distribution companies and the comparable retail distribution companies on a separate basis. Then, the results of the wholesale and retail distribution company data sets were combined, with an 80% weight given to the wholesale data set and 20% weight given to the retail data set.

257. The Paint Stores Division was determined to have generated three-year average operating profit margins of 1.67%. On a three-year average basis, the Paint Store generated operating margins that fell within the three-year interquartile range for comparable wholesale distribution companies that generated operating margins between 0.07% and 2.81%. For 1991, the Paint Stores Division operating margin was determined to be 0.56%. That operating margin

fell within the 1991 interquartile range for comparable wholesale distribution companies that generated operating margins between -1.36% and 1.08%.

The Paint Stores Division’s three-year average operating margins of 1.67% did not fall within the three-year interquartile range for comparable retail distribution companies that generated operating margins between 3.15% and 4.68%. The Paint Stores Division’s 1991 operating margin of 0.56% did not fall within the 1991 interquartile range for comparable retail distribution companies that generated operating margins between 3.04% and 4.54%.

The weighted combined set results in a three-year average interquartile range of 0.69% and 3.18% for the comparable companies. The Paint Stores Division’s average three-year operating margin of 1.67% exceeded the median result (1.66%) of the comparable companies and fell within the three-year average interquartile range of the distribution companies. The 1991 interquartile range of the weighted combined set of comparable distribution companies was determined to be between -0.47% and 1.78%. The Paint Stores Division’s operating margin of 0.56% for 1991 exceeded the median result (0.02%) of the comparable companies and fell within the 1991 interquartile range developed from the combined weighted set.

258. Although the Transportation Division does not directly sell products and therefore does not pay a royalty, Grant Thornton performed a profitability analysis because that division is an integral operating unit of Sherwin-Williams and charges the other operating divisions for its transportation services. Grant Thornton determined that the Transportation Division generated three-year average fully-loaded cost plus markups of 9.09%, which was slightly higher than the 8.81% upper quartile exhibited by the comparable transportation companies. During 1991, the Transportation Division’s fully-loaded cost plus markup of 8.55% also was above the 0.51% and

7.48% interquartile range of the comparable companies. According to Grant Thornton that indicates that the Transportation Division earned somewhat higher profits than what other transportation companies generated in that year. Although the Transportation Division's profitability was slightly higher than that exhibited by the upper quartile of the sample, its operating results fell within the range of -15.7% and 24.7% generated by all the comparable companies, and therefore was considered arm's length (Treas Reg § 1.482-1[e][2][iii][A]).

259. Mr. Hasenwinkle's analysis reached the conclusion that, on an overall basis, Sherwin-Williams was generating an arm's-length level of profit after payment of the royalties. He therefore concluded that the royalty rates paid by Sherwin-Williams' operating divisions were at arm's length.

Analysis of Interest Rate

260. An analysis was performed to determine whether the terms of the loan agreement entered into by SWIMC and Sherwin-Williams were at arm's length. In determining whether SWIMC's loan to Sherwin-Williams was at an arm's-length rate of interest, the initial inquiry is whether the loan constitutes a bona fide debt under Treasury Regulation § 1.482-2. Loan characteristics (e.g., term, interest rate, security) are then analyzed to determine whether the interest charged was at arm's-length rate.

Mr. Hasenwinkle first determined that SWIMC's loan was bona fide debt. He then concluded, based upon a comparable financing arrangement that Sherwin-Williams had with National City Bank that bore the identical interest rate, that the interest rate charged by SWIMC was at arm's length.

Analysis of Charges for Legal Services

261. An analysis was performed to determine whether the prices Sherwin-Williams charged SWIMC and DIMC for the trademark legal services it rendered for them were at arm's length.

Treasury Regulation § 1.482-2 requires that services must provide a benefit to the recipient. Mr. Hasenwinkle concluded that the requirement was met here since SWIMC and DIMC would have had to hire an intellectual property lawyer to render the necessary services if Sherwin-Williams had not been retained. Mr. Hasenwinkle determined that the rates Sherwin-Williams charged SWIMC and DIMC for the trademark and licensing legal services it rendered fell within the range established by AIPLA of rates charged for the performance of trademark and licensing legal services in the Cleveland/Akron geographical area. Mr. Hasenwinkle determined that the prices charged by Sherwin-Williams were therefore at arm's-length rates.

262. Mr. Hasenwinkle concluded, based upon his analysis, that each of the intercompany transactions - - the license of the Marks by SWIMC and DIMC to Sherwin-Williams, the loan made by SWIMC to Sherwin-Williams, and the provision of legal services by Sherwin-Williams to SWIMC and DIMC - - clearly passed IRC § 482 muster. Mr. Hasenwinkle therefore concluded that all transactions between Sherwin-Williams and SWIMC and Sherwin-Williams and DIMC were conducted at arm's length.

263. At the hearing, petitioner submitted into evidence two reports prepared by Richard W. Genetelli, a Certified Public Accountant and the founder and principal owner of the Genetelli Consulting Group, which specializes in state and local tax matters. Mr. Genetelli

testified at the hearing concerning his findings in those two reports. Mr. Genetelli was accepted as an expert in state and local tax and accounting matters related to this case.

Separate Accounting Report

264. Mr. Genetelli prepared a report evaluating the appropriateness of the Division's proposal to force Sherwin-Williams to file on a combined basis with SWIMC and DIMC (the "Genetelli Report"). The report was prepared after discussions with Sherwin-Williams personnel and after reviewing Sherwin-Williams' Federal and New York State tax returns, annual reports, Forms 10-K and other financial and other internal documentation.

265. The report concluded that the combined reporting should not be required because "the income and activities of The Sherwin-Williams Company are more accurately reflected in New York State on a separate company basis." Mr. Genetelli performed an analysis of the net income generated by Sherwin-Williams in New York State based on a separate accounting concept.

266. In preparing his separate accounting report, Mr. Genetelli found that, in 1991, Sherwin-Williams had 64 paint stores and two automotive branches in New York State. With respect to the paint stores, Mr. Genetelli found that approximately 80 percent of the revenue generated by the paint stores was attributable to sales to wholesalers/contractors. He found that the Consumer Brands, Specialty, Chemical Coatings and International divisions solicited sales in New York State in 1991. He also determined that Sherwin-Williams' Corporate and Real Estate divisions provided intercompany services in New York State in 1991.

267. Since Sherwin-Williams keeps its books on a divisional basis, not a state-by-state basis, he determined the appropriate amounts of income and expense that should be attributable

to New York State for 1991 for each of the divisions conducting activity in New York State. All items of income were based on actual figures. To the extent possible, Mr. Genetelli attributed items of expense to New York State based on actual figures. Where actual figures were not available, Mr. Genetelli used methods described below to attribute expense items to New York State.

268. For the paint stores, Mr. Genetelli allocated the national advertising expense based on sales of the various geographic operating divisions.

269. The Genetelli report imposes internal interest charges ("notional interest") on accounts receivable, other receivables, and on inventory to the paint stores. Mr. Genetelli used an internal interest rate of 12%, the rate personnel at Sherwin-Williams told him was used. During his testimony, Mr. Ault confirmed that the Corporate Division uses an internal interest rate of 12% in its charges to the various divisions for working capital and fixed assets.

270. In his report, Mr. Genetelli charged the New York paint stores with $1,445,979.00 in net internal interest, the impact of which is to convert the net income of $794,383.00 for the New York paint stores to a net loss of ($661,596.00).

271. In his report, Mr. Genetelli allocated the Corporate Overhead Expense to each of the New York paint stores based on a proportion of the New York paint stores sales to the total Paint Stores Division's sales. He did not allocate any Corporate overhead income to New York State.

272. Based on the separate accounting that he performed of Sherwin-Williams, Mr. Genetelli determined that Sherwin-Williams had $1,008,379.00 of entire net income attributable to New York State. Using combined reporting, the Division asserted that Sherwin-Williams'

entire net income apportioned to New York State was $5,567,127.00, or 550 percent of the amount determined by using separate accounting.

Arm's-Length Analysis

273. Mr. Genetelli also concluded in a separate report that all transactions between Sherwin-Williams and SWIMC and all transactions between Sherwin-Williams and DIMC were at arm's length. Specifically, the royalty and interest rates charged by SWIMC and DIMC to Sherwin-Williams were at arm's-length rates, as were the charges by Sherwin-Williams to SWIMC and DIMC for the trademark protection services that Sherwin-Williams performed.

274. The results of Mr. Genetelli's arm's-length analysis are memorialized in a report dated November 19, 1998 ("Genetelli arm's-length study"). In analyzing the intercompany transactions, Mr. Genetelli used IRC § 482 and the 1994 Treasury regulations. He determined that the best methods for analyzing the royalty rates paid by Sherwin-Williams for its use of SWIMC's and DIMC's Marks are the CPM and the PSM.

275. In the application of the CPM, Mr. Genetelli determined whether the royalties paid by Sherwin-Williams to SWIMC and DIMC were at arm's length "by comparing Sherwin-Williams' profitability, after deducting royalties, to objective measures of profitability derived from comparable companies engaged in the same line of business as Sherwin-Williams." For purposes of applying the CPM, as well as the PSM, research and development costs were added back to the operating profit figures of Sherwin-Williams and those of the comparables. This is because research and development expenditures may be capitalized and the benefit of such expenditures is derived over future years.

276. In his arm's-length study, Mr. Genetelli states that the PSM determines the appropriate royalty by dividing the profits between Sherwin-Williams and SWIMC and DIMC. In his study, Mr. Genetelli, for purposes of the PSM, applied the widely recognized economic principle that the royalty paid to licensors is generally between 25% and 33% of the profit attributable to the employment of the subject intangibles.

277. Mr. Genetelli determined single composite royalty rates of 2.82 % and 3.51% representing royalties paid to SWIMC and DIMC, respectively. These royalty rates were computed by dividing the total royalties paid to SWIMC and DIMC, respectively, by total respective net sales subject to royalties. According to Mr. Genetelli's study, a single composite rate approach reflects the true effective overall royalty rate paid by Sherwin-Williams in 1991 to SWIMC and DIMC. In addition, use of a single royalty rate for Sherwin-Williams is essential to the comparability analysis since the royalty rates for uncontrolled entities would customarily be stated as a single rate.

278. Mr. Genetelli determined that the CUT method was inapplicable because he could not identify any comparable uncontrolled transactions involving substantially similar intangibles for which sufficient relevant data was available.

279. The Genetelli arm's-length study determined that Sherwin-Williams was the appropriate tested party. The selection of the comparables is the next step under the CPM. Various financial data bases, including, among others, Compact Disclosure, Laser Disclosure and Dun & Bradstreet, were searched to locate suitable comparables.

280. The comparables search revealed several suitable comparables specializing in the manufacture and sale of paints, sealants and adhesives, resins and related products. The

comparables selected were: (1) Benjamin Moore & Co.; (2) RPM, Inc.; (3) The Valspar Corporation; (4) Lilly Industries, Inc.; and (5) H.B. Fuller Co. Two arm's-length ranges were established, one based on the operating profit margins derived from all the comparables and the other based on the rate of return on capital employed (also known as "rate of return on assets").

281. The Genetelli study includes a description of the five comparable companies. All five comparable companies are engaged in manufacturing a diverse range of coatings and distributing them to a broad section of consumers.

282. Two profit level indicators were used in the Genetelli study. They were "operating profits as a percentage of sales" ("operating profits PLI") and rate of return on capital employed"("ROR PLI"). The operating profits PLI measures the relationship between profit to sales, while the ROR PLI is the ratio of operating profit to operating assets. The study states that adjustments for small differences between Sherwin-Williams and the comparables were, nevertheless, made to accounts receivable and accounts payable levels, as well as inventory. The adjustments were computed using the method prescribed in Treasury Regulation § 1.482-5(e). The accounts receivable adjustments were a product of the following three factors: (1) the difference between Sherwin-Williams' ratio of accounts receivable to sales and that of each comparable; (2) the average prime rate for the year; and (3) sales of the comparable company in question. The same approach was used to compute the inventory adjustments. Again, the accounts payable adjustments were computed in the same manner, but the results were multiplied by negative one. Mr. Genetelli determined that because these adjustments have been made, the arm's-length range is the entire range of constructive operating profits (Treas Reg § 1.482-1[e][3][iii]). Mr. Genetelli provided the profitability figures for the years 1989 through

1991 for Sherwin-Williams and the comparable companies in accordance with Treasury Regulation

§ 1.482-5(b)(4).

283. To determine whether the royalty rates paid by Sherwin-Williams to SWIMC and DIMC were at arm's length, the Genetelli arm's-length study compared Sherwin-Williams' "adjusted operating profit" to the constructive operating profits for each of the comparable companies. The study computed each comparable company's operating profit and then adjusted it by adding back research and development expense and made adjustments in its accounts receivable, payable and inventory accounts. Mr. Genetelli computed the constructive operating profits by applying the profit percentage or ratios derived from the comparable companies' financial data to the financial data of Sherwin-Williams. For example, Benjamin Moore & Co.'s constructive operating profit for 1991 was determined to be $374,394.00. Mr. Genetelli computed that figure by multiplying Sherwin-Williams' sales ($2,541,446.00) for 1991 by Benjamin Moore & Co.'s adjusted operating profits percentage for 1991 of 14.7315%.

284. The Genetelli arm's-length study determined that Sherwin-Williams' operating profit of $233,676.00 fell within the range of the constructive operating profits of the comparable companies using both an "operating profits PLI" and a "return on assets" PLI. Specifically, Mr. Genetelli's study determined the arm's-length range of the 1991 constructive operating profits based on the operating profits PLI to be from $220,118.00 to $374,394.00. The arm's-length range of the 1991 constructive operating profits based on the return on operating assets ("ROR") PLI was determined to be $188,444.00 and $416,559.00.

285. In his application of the PSM, Mr. Genetelli applied the 25% to 33% profit split. In the study, Mr. Genetelli explained that this method divides the operating profit of the licensee and licensor, with a 25 percent to 33 percent share of the operating profits going to the licensor in the form of royalty and the remainder being retained by the licensee. According to Mr. Genetelli, "multiplying operating profit figure of a licensee by 25 percent and 33 percent produces a range of royalty rates that would be acceptable to both a licensee and licensor in an arm's-length transaction."

286. Mr. Genetelli applied the 25% to 33% range to the adjusted operating profits figures of each of the comparable companies and Sherwin-Williams. Mr. Genetelli calculated Sherwin-Williams' adjusted operating profit by taking the company's unadjusted operating profits plus the royalties paid for 1991, plus research and development expenditures. In the study, Mr. Genetelli explains that the royalties were added back to profits to arrive at the gross figure to be apportioned between the licensor and licensee, in order to determine what portion of the profit represents royalties due to the licensor.

287. Mr. Genetelli determined a range of 1991 royalty rates of 2.17% to 4.86% for the lower and upper ends of the range, respectively for the five comparable companies examined. He determined the range of royalty rates that would result for Sherwin-Williams when the 25% to 33% profit split formula is applied to be 2.75% to 3.63%. The actual royalty rates paid by Sherwin-Williams to SWIMC (2.82%) and DIMC (3.51%) fell within the two arm's-length ranges developed by Mr. Genetelli using this profit split approach.

288. The Genetelli study determined that Sherwin-Williams' profitability figures fell within both of the arm's-length ranges established under the CPM. It also determined that the

royalty rates fell within the range of arm's-length royalty rates created using the PSM. In the study, Mr. Genetelli found the royalty rates paid by Sherwin-Williams to SWIMC and DIMC to be at arm's length.

289. As part of the arm's-length study, Mr. Genetelli also reviewed the interest rate charged by SWIMC on the loan that it made to Sherwin-Williams to determine if the rate charged was at arm's length. He identified a revolving line of credit agreement entered into between National City Bank and Sherwin-Williams, which agreement was outstanding at the same time as SWIMC's loan to Sherwin-Williams. The 5.8125% rates on both the line of credit and the SWIMC loan were identical. Mr. Genetelli concluded that the interest rate SWIMC charged Sherwin-Williams was an arm's-length rate.

290. Mr. Genetelli also determined that Sherwin-Williams' charges for services rendered to SWIMC and DIMC under the services agreements were at arm's length. Three separate analyses of the rates, i.e., on an hourly basis, on a task basis and on a project basis, were performed in reaching that conclusion.

The Division's Expert Witnesses

291. At the hearing, the Division presented the testimony of Dr. Alan C. Shapiro, and submitted into evidence two reports prepared by Dr. Shapiro. Dr. Shapiro's testimony and reports critiqued the AAA appraisal and the Grant Thornton Transfer Pricing Report and addressed the economic substance of SWIMC and DIMC.

292. Dr. Shapiro has a Ph. D. in economics from Carnegie Mellon University and has taught economics and finance for more than 25 years. He is the Ivadelle and Theodore Johnson Professor of Banking and Finance at the Marshall School of Business at the University of

Southern California. Dr. Shapiro has written five books on the topic of corporate finance. He has testified as an expert in transfer pricing and valuation issues and whether transactions have economic substance. Dr. Shapiro did not prepare a transfer pricing report. He was accepted as an expert in economics, transfer pricing and corporate finance.

293. Based on his background in economics and value based management, Dr. Shapiro testified about the economic substance of Sherwin-Williams' assignment of the Marks to SWIMC and DIMC and its non-exclusive license back of the Marks. He concluded that there was no economic substance underlying the formation of SWIMC and DIMC.

294. It was Dr. Shapiro's opinion that SWIMC and DIMC are unable to add value to the trademarks. He testified that if SWIMC and DIMC were very actively involved in brand management, through the exercise of their rights under the licensing agreements with petitioner (e.g., the right to approve brand extensions, the right to review and approve advertising, the right to engage in quality control), petitioner would be subjecting itself to great risks because SWIMC and DIMC would be engaging in brand management without the necessary information to make intelligent decisions. That is, if SWIMC and DIMC actually made critical brand management decisions, they would destroy value because their personnel do not have the information and experience needed to make those decisions correctly. Therefore, according to Dr. Shapiro, the assignment and license back transaction would have no economic substance because there was no rational expectation that the benefits of the transaction would exceed its costs.

295. Conversely, according to Dr. Shapiro, if SWIMC and DIMC were only nominally involved in brand management, the assignment and license back transaction would merely be

creating an unnecessary level of corporate bureaucracy that does not add any value to the overall enterprise, i.e., there would be no rational expectation of profit from the transaction.

296. Dr. Shapiro admitted that SWIMC and DIMC were involved in some aspects of brand management such as quality control, trademark renewal decisions and third-party licensing.

297. Dr. Shapiro testified that from an economic perspective, it would be irrational to put someone in charge of the trademarks who is outside of petitioner's organization and who has no knowledge of its brands, customer requirements and corporate capabilities.

298. According to Dr. Shapiro, the assignment and license back transaction would not have any economic substance even if SWIMC and DIMC consulted with petitioner's brand managers as to how the trademarks should be used. It was his opinion that the least likely alternative that one would select would be to take somebody who is not part of the internal organization, who has no knowledge of the brands, the products, customer requirements, or corporate capabilities and place that person in another location with responsibility to make decisions related to brand management.

299. According to Dr. Shapiro, it would not make sense from an economic perspective for a successful company that adds value to the trademarks to sell its trademarks to a third party and remain in the core business. Economic theory would predict that a company would not sell its trademarks to a third party while remaining in business except under extreme circumstances such as dire economic distress. An unsuccessful company, one that does not have the necessary intangibles to exploit a trademark might assign the mark. A successful company, by definition, has a host of other intangible assets in its core business. The excess returns earned on branded

products are directly related to the amount of other intangible assets the company is employing. Hence, it would expect to earn higher returns by using the marks itself as opposed to selling them off.

300. Dr. Shapiro opined that the creation of SWIMC and DIMC and the assignment of the trademarks to those subsidiaries adds significant complexity to the accountability process regarding use and management of the marks.

301. In Dr. Shapiro's view, the assignment of a trademark to a subsidiary that is managed by an outsider who does not understand the brand value proposition underlying the trademark is not a rational way to engage in third-party licensing. Dr. Shapiro suggested some other ways for petitioner to enhance the amount of third-party licensing revenue, including giving SWIMC and DIMC the right to license the trademarks to third parties.

302. It was Dr. Shapiro's opinion that having SWIMC and DIMC do quality control is either dangerous or redundant.

303. According to Dr. Shapiro, it does not make sense from an economic perspective for petitioner to create SWIMC and DIMC for the purpose of engaging in securitization until the specific need arises. It was his opinion that petitioner could segregate the cash flow pertaining to the trademarks by simpler means than using SWIMC and DIMC as vehicles for securitization.

304. Dr. Shapiro testified that selling off assets that are intimately linked to the operation of petitioner's core business in order to forestall a hostile takeover would go beyond the "crown jewels" defense. According to Dr. Shapiro, the sale of such assets would make no economic sense.

305. Petitioner had, prior to the formation of SWIMC and DIMC, adopted a “poison pill” anti-takeover defense. According to Dr. Shapiro, it does not necessarily make economic sense for the management of a corporation to maximize the number of anti-takeover defenses.

306. Dr. Shapiro testified that, assuming the conveyance of the trademarks to a third party is an effective anti-takeover defense, a rapid conveyance of the trademarks is not critical to the success of the defense. The transfer of trademarks can be effectuated by a simple sales contract; it is not necessary to record the transfer of the trademarks with the U.S. Patent and Trademark Office in order to effectuate a transfer of the trademarks.

307. He also testified that transferring assets from petitioner to SWIMC and DIMC does not prevent petitioner’s creditors from seizing those assets because its stock in the subsidiaries is an asset owned by petitioner and, thus, could be seized by petitioner’s creditors.

308. Dr. Shapiro acknowledged that corporations have the right to transfer their assets into separate companies without geographic restriction.

Dr. Shapiro’s Critique of the AAA Report

309. In his report, Dr. Shapiro concludes that AAA’s conclusions were inconsistent with economic reality, a condition stemming from major methodological problems with the analysis.

310. According to Dr. Shapiro, AAA improperly applied the 25% to 33⅓% profit split. If the profit split is applied in the manner proposed in the AAA report, petitioner would be unable to earn its cost of capital on the operating, i.e., tangible assets necessary to produce the branded products. For example, a 33% split applied to operating profit would have left Sherwin-Williams earning over two percentage points less than its cost of capital.

311. Dr. Shapiro testified that it does not make sense from an economic perspective to apply the profit split percentage to total net profit. According to Dr. Shapiro, the 25% to 33% rule of thumb should be applied to residual profit. Dr. Shapiro's report applied the 25% to 33% profit split rule of thumb to Sherwin-Williams' residual operating profits (by calculating its return on assets and subtracting its weighted average cost of capital) and found that, so calculated, the royalty rates petitioner would have paid would be in the range of between .41% and .54% of net sales.

312. According to Dr. Shapiro, AAA overestimated the appropriate cost of capital to apply to the projected royalty cash flows. As a result of this overestimation, AAA underestimated the value of the trademarks assigned to SWIMC and DIMC. Dr. Shapiro found that the beta estimated by Value Line for petitioner in 1991 was 1.20. He determined that a conservative estimate of beta for petitioner's royalty payments would be one-half of petitioner's overall beta (0.6) and determined a cost of equity capital for the royalty income equal to 12.34%. Dr. Shapiro then used a weighted average cost of capital of 12% and computed the fair market value of the trademarks to be $658,300,000.00, almost double the value determined by AAA.

We modify finding of fact "313" of the Administrative Law Judge's determination to read as follows:

> 313. Dr. Shapiro testified that it did not make any sense from an economic perspective that petitioner's trademarks accounted for approximately 76% of petitioner's total intangible value. He also testified that the other intangible assets of petitioner such as multiple distribution channels, and the ability to adapt to a changing marketplace, were worth more than 25% of petitioner's total intangibles.[30]

[30]We modified finding of fact "313" by deleting the last sentence due to irrelevance.

Dr. Shapiro's Critique of the Grant Thornton Transfer Pricing Report

We modify finding of fact "314" of the Administrative Law Judge's determination to read as follows:

> 314. Dr. Shapiro agreed that the CPM is a valid method under IRC § 482.[31]

315. Dr. Shapiro testified that there was a flaw in Grant Thornton's search methodology, specifically, the exclusion of companies with substantial intangibles. He testified that the effect of excluding companies with substantial intangibles is to push the interquartile range in a downward direction because companies with substantial intangibles are likely to be the most profitable companies in an industry because they are earning returns on those intangibles. The intangibles that contribute to a company's success include a good distribution system, technological assets, marketing skills, and organizational capabilities that allow its workforce to work effectively together to design, develop, produce, distribute and market a branded product.

We make the following additional finding of fact.

> Dr. Shapiro noted that it was inconsistent for Grant Thornton to, on the one hand, separately analyze Sherwin-Williams' manufacturing divisions and, on the other hand, compare them to the consolidated financial results of diversified companies, only a part of whose business relates to the production of coatings, such as PPG and Grow Group.

316. Dr. Shapiro testified that market level is important in the selection of comparables. The economics of making retail sales and OEM sales are completely different. The vastly larger

[31]We modified finding of fact "314" to more accurately reflect the record.

volume of a sale to an OEM will cause a seller to accept a smaller margin in exchange for achieving a higher asset turnover.

317. Dr. Shapiro testified that sales volume and geographic scope should be taken into account when comparables are chosen. He testified that regional companies would not be as comparable to petitioner as national companies because regional companies would be subject to the region's economic cycle that might be different from the national economic cycle.

318. Dr. Shapiro pointed out that in 1991 the Northeast suffered a recession that was more severe than the national economy's recession. According to Dr. Shapiro, the effect of using regional companies doing business in the Northeast in 1991 would bias the interquartile range downwards.

Dr. Shapiro's Critique of the Genetelli Separate Accounting Report.

319. Dr. Shapiro reviewed the separate accounting report. He testified that he was unable to verify the numbers in that report, as he was unable to tie the numbers in the separate accounting report back to petitioner's audited financial statements.

320. Dr. Shapiro noted that the Genetelli separate accounting report imputes notional internal interest to petitioner's operating divisions even though there is no such interest expense on petitioner's Federal income tax return. He testified that the imputation of notional internal interest causes income to be severely understated in the Genetelli separate accounting report.

Dr. Shapiro's Critique of the Genetelli Arm's-Length Analysis

321. Dr. Shapiro testified that it was an error for the Genetelli pricing report to add back the royalties petitioner paid to SWIMC and DIMC in computing petitioner's operating margins for purposes of the report's profit split test because the royalties paid by the operating divisions

to SWIMC and DIMC simply wash out on a consolidated basis. According to Dr. Shapiro, by adding back the divisions' royalty expense, the Genetelli pricing report double-counted that expense, causing the report to derive a higher royalty rate than it would have otherwise.

322. Dr. Shapiro testified that it was also erroneous for the Genetelli pricing report to add back petitioner's research and development expense without adding any amortized expense for research done by petitioner in the past that is still benefitting it today.

Bromberg Testimony

323. At the hearing, the Division presented the testimony of Lee Carl Bromberg, a trademark attorney, and submitted into evidence a report prepared by Mr. Bromberg.

324. Mr. Bromberg is a partner with the Massachusetts law firm of Bromberg & Sunstein LLP. Mr. Bromberg's practice concentrates on complex commercial cases with special emphasis on patent, trademark, copyright, trade secret, unfair competition and related cases in high technology areas. Mr. Bromberg was accepted as an expert in trademark law and practice.

325. Mr. Bromberg's testimony and report concluded that the transfer and license-back of the trademarks does not result in any advantages as a matter of trademark law, practice and strategy. Mr. Bromberg further concluded that the transfer and license-back entails several significant disadvantages with respect to the trademarks, and a serious risk to their invalidation.

326. Mr. Bromberg, in his report and testimony, stated that, in his opinion, Sherwin-Williams is the entity that generates all the goodwill for the Marks after assignment to SWIMC and DIMC.

327. Mr. Bromberg testified that if SWIMC and DIMC are independent trademark managers there is a risk of a naked assignment and naked license back. He testified that the

assignment of the trademarks to SWIMC and DIMC could be determined to be a mere transfer of paper title without goodwill and thus an assignment in gross that would render the trademarks invalid.

328. Mr. Bromberg acknowledged that SWIMC and DIMC are the legal owners of the trademarks. He further acknowledged that he knew of no instances where there have been holdings that the Sherwin-Williams assignment and license-back of trademarks resulted in naked licensing.

329. It was Mr. Bromberg's opinion that there were simpler and more efficient ways to achieve the benefits outlined by Sherwin-Williams in its business plan.

330. Mr. Bromberg testified that the 2.8% average royalty rate that Sherwin-Williams was charged for its use of the Marks under the License Agreements with SWIMC and DIMC was "in the ballpark of transactions" in which he has been involved. Mr. Bromberg testified that he had first hand experience with a company that owned trademarks, but did not have any ongoing business.

391. At the conclusion of the hearing both parties made motions. Petitioner made two motions. The first was a motion to have Mr. Pragel's testimony stricken from the record, and the second was a motion to have a negative inference drawn from the Division's response to petitioner's subpoena. The Division also made two motions. The first was a motion to have material protected by the attorney-client privilege stricken from the record, and the second was a

motion to have a negative inference drawn from petitioner's failure to fully comply with the Division's subpoena.[32]

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination, the Administrative Law Judge began by addressing four motions (two motions brought by each party) presented to her for consideration. The first motion dealt with whether the testimony of Mr. Pragel, a Division fact witness who was present in the hearing room for a number of days of the hearing, should be stricken from the record for violating the Administrative Law Judge's directive that all fact witnesses were to be excluded from the hearing unless testifying. The Administrative Law Judge refused to strike the testimony because she determined that Mr. Pragel's presence in the hearing room was not a willful disregard of her order, but rather, a mistake made on the part of the Division. The Administrative Law Judge did note that she would review the testimony of Mr. Pragel in light of the fact that he was in the room during the testimony of some of petitioner's witnesses.

The next motion considered by the Administrative Law Judge was petitioner's request that negative inferences be drawn for the Division's failure to comply with the subpoena issued by petitioner. The Administrative Law Judge denied this motion on the basis that in order for a negative inference to be drawn for the failure to submit a document, it has to primarily be shown that the document, in fact, exists and such documents are within the Division's control. The Administrative Law Judge determined that petitioner failed to establish the existence of the documents and, therefore, the Administrative Law Judge rejected petitioner's motion.

[32]We deleted findings of fact numbered "331" through "390" of the Administrative Law Judge's determination as irrelevant to the disposition of the issue herein and we conclude that their inclusion as findings of fact was superfluous. The specific deleted facts related to the four motions outlined in finding of fact "391."

The Administrative Law Judge then dealt with the Division's motion concerning certain documents and testimony which the Division claims are entitled to attorney-client privilege and, as such, should be stricken from the record in this proceeding. The Administrative Law Judge held that since the documents at issue were given to petitioner's representative inadvertently, the Division, in effect, waived any entitlement to privilege based upon such error. Additionally, in reviewing the documents at issue, the Administrative Law Judge concluded that such documents were not privileged communications.

Moreover, with respect to the testimony of the Division's three witnesses which it seeks to have stricken from the record, the Administrative Law Judge stated that since all three witnesses testified to questions asked by the Division, such responses waived any entitlement to privilege that the Division could assert.

The last motion addressed by the Administrative Law Judge was whether negative inferences should be drawn against petitioner for failure to comply with the subpoena served upon it by the Division alleging that petitioner conducted merely a superficial attempt at complying with the subpoena. Although the Administrative Law Judge agreed with the Division that petitioner did not make a good faith attempt at complying with the subpoena, she concluded that the evidence sought would not be substantial, but rather, cumulative to the extensive record created that included 172 exhibits already made part of the record. Thus, she rejected the Division's motion to draw negative inferences.

The Administrative Law Judge next turned to the issue in this case which was whether petitioner herein was required to filed a combined franchise tax report with two of its subsidiaries, SWIMC and DIMC. The Administrative Law Judge concluded that petitioner was not required to file a combined report with SWIMC and DIMC. In her exhaustive and extensive review of the voluminous record created by the parties in this matter, the Administrative Law Judge reasoned that SWIMC and DIMC were created by petitioner for a legitimate business purpose and not merely for a tax avoidance purpose.

The Administrative Law Judge set forth the test for determining whether transactions between controlled corporations will be respected. The two-prong test is whether the transactions were accomplished for a valid business purpose and whether the transactions had economic substance. The Administrative Law Judge determined that SWIMC and DIMC were, in fact, formed for valid business purposes and carried out substantial business in their own names. The Administrative Law Judge stated that SWIMC and DIMC were created to hold and manage the Marks, to increase the protection of the Marks, to license the Marks to both related and unrelated entities, to take advantage of a favorable corporate environment, to avert hostile takeover, to maximize their investments and to provide for an additional source of financing. The Administrative Law Judge concluded that the assignment of the trademarks by petitioner to SWIMC and DIMC and the license-back of those trademarks to petitioner were accomplished for valid business purposes, were characterized by economic substance and were not motivated solely for tax avoidance purposes.

The Administrative Law Judge also found that the royalty rates determined by AAA were appropriate and at arm's length. The Administrative Law Judge stated that she agreed that AAA applied the correct rule of thumb in this case and coupled with the testimony of Mr. Billovits and other exhibits in the record, that the royalty rates were, indeed, at arm's-length rates.

The Administrative Law Judge next addressed whether petitioner rebutted the presumption of distortion in this case by showing that the transactions between the corporations were at arm's length. In analyzing this particular issue, the Administrative Law Judge focused on the transfer pricing report prepared by Grant Thornton which analyzed the intercompany transactions between SWIMC and DIMC in accordance with the IRC § 482 regulations as well as the reports prepared by Mr. Genetelli.

After exhaustively analyzing both reports and the arguments made by the parties herein, the Administrative Law Judge concluded that the Grant Thornton CPM analysis established that the royalties paid by petitioner to SWIMC and DIMC during the period in issue were at arm's length; that the Grant Thornton interest rate analysis established that the interest rate charged by SWIMC on its loan to petitioner was at arm's length; that the Grant Thornton intercompany services analysis established that the rates charged by petitioner for the trademark services performed for SWIMC and DIMC were at arm's length. With respect to the Genetelli arm's-length analysis, she found many flaws in it as outlined in her determination and, thus, rejected the report as proof that the royalty rates were at arm's length. However, the Administrative Law Judge noted that the Genetelli report did support petitioner's position that the interest rate SWIMC charged petitioner was an arm's-length rate and that the rates charged by petitioner for the trademark services performed for SWIMC and DIMC were at arm's length.[33]

Thus, the Administrative Law Judge concluded that petitioner did rebut the presumption of distortion in this case and that the Division did not establish the existence of distortion in

[33]Since the Administrative Law Judge rejected the Genetelli arm's-length analysis as proof that the royalty rates at issue were at arm's length and since an exception was not filed with respect to her conclusion regarding said report, we will not address it in our decision herein.

connection with the royalties, the interest rate or the charges for the intercompany services. Accordingly, the Administrative Law Judge determined that the Division may not require petitioner to file a combined report with SWIMC and DIMC for the year 1991.

ARGUMENTS ON EXCEPTION

In its exception, the Division disagrees with several of the findings of fact made by the Administrative Law Judge as well as most of her conclusions in her determination. As succinctly stated as possible, the Division contends that the assignment and license-back of the Marks lacks economic substance. The Division states that petitioner never gave up control of the Marks and never intended to do so. The Division argues that trademark management requires experience and knowledge of the particular business and that petitioner could not have intended to transfer its Marks to the subsidiaries in question since there is no economic reason for doing so aside from avoiding taxes.

The Division claims that the Administrative Law Judge committed four critical errors in her determination that require a reversal of her conclusion. The Division argues that the Administrative Law Judge failed to properly apply the objective economic substance test, failed to address whether the form of the transaction matched the substance, improperly relied on self-serving testimony to decide the subjective prong of the economic substance test and improperly relied on expert reports to decide the arm's-length pricing issue since such reports made unjustifiable assumptions about petitioner and failed to follow the IRC § 482 regulations.

In opposition, petitioner asserts that the subsidiaries have a valid business purpose. Petitioner states that the subsidiaries had two offices and that it hired Dr. Puglisi, an expert in financial matters, as president of SWIMC and DIMC. Petitioner alleges that Dr. Puglisi was the perfect fit for the job to bring in more of a financial return in procuring third-party licenses of the Marks than petitioner. Petitioner argues that the Marks were transferred for several legitimate reasons as outlined by the Administrative Law Judge. Petitioner disagrees with the Division's assertion that the Grant Thornton transfer pricing report is flawed. Petitioner states that Grant Thornton has done hundreds of these type of transfer pricing reports and that it was correct. The correct comparables were utilized and the geographic market employed was correct.

Petitioner reasserts its belief that the Division is treating it as if New York State was a unitary state which it is not. Petitioner claims that the Division always combines cases similar to this and petitioner states that such a tactic is wrong. Petitioner argues that this case is fact intensive and when the facts are analyzed objectively, it has rebutted the presumption of distortion as found by the Administrative Law Judge below.

OPINION

Article 9-A of the Tax Law imposes a tax on foreign corporations doing business in New York State (Tax Law § 209[1]). In order to properly reflect that tax liability, Tax Law § 211(4) gives the Division the discretion to require or permit corporations subject to New York State tax to file combined reports with certain other corporations. The statute requires that the parent own or control substantially all of the stock of the subsidiary. The statute further limits the Division's discretion by providing that "[n]o combined report covering any corporation not a taxpayer shall be required unless the [Division] deems such a report necessary, because of inter-company transactions . . . in order properly to reflect the tax liability" (Tax Law § 211[4]).

The Division's regulations provide that the Division may require or allow the filing of a combined report where three conditions are met: (1) a stock ownership test (20 NYCRR 6-

2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3). The distortion of income test provides, in pertinent part, that the Division:

> may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations (20 NYCRR 6-2.3[a]).

Furthermore, the regulation states that: "[t]he substantial intercorporate transaction requirement may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities described in this subdivision" (20 NYCRR 6-2.3[c]).

We have held that where a taxpayer corporation and related corporations are found to meet the requirements set forth above in the Division's regulations, a rebuttable presumption arises that the taxpayer corporation's New York income will not be properly reflected without reporting on a combined basis (***see***, ***Matter of Silver King Broadcasting of N.J.,*** Tax Appeals Tribunal, May 9, 1996; ***Matter of Standard Mfg. Co.***, Tax Appeals Tribunal, February 6, 1992). This is the presumption of distortion.

For purposes of this matter, there is no dispute that the stock ownership and unitary business requirements have been met. As stated above, there exists a presumption of distortion where there are substantial intercorporate transactions among the corporations. Therefore, the issue in this case devolves to whether petitioner, in fact, has rebutted the presumption of distortion. We conclude that it has not and we reverse the determination of the Administrative Law Judge.

Ultimately, the issue of whether petitioner has rebutted the presumption of distortion is a question of fact. "Although we defer to the Administrative Law Judge's evaluation of the credibility of the witness, we are not bound by that determination" (***Matter of Wachsman***, Tax Appeals Tribunal, November 30, 1995; ***see***, ***Matter of Stevens v. Axelrod***, 162 AD2d 1025, 557 NYS2d 809; ***see also***, ***Matter of Spallina***, Tax Appeals Tribunal, February 27, 1992). The record made in this proceeding is enormous. The transcript of the hearing exceeds 3,700 pages and the exhibits number over 150 in total. In her determination, the Administrative Law Judge relied heavily on testimony presented by certain witnesses while dismissing other testimony outright without explanation. After reading the entire record, we find that the Administrative Law Judge erred in finding certain facts and conclusions based upon the documentation and the expert testimony comprising the record in this proceeding.

SWIMC and DIMC were incorporated in Delaware on January 31, 1991. Under their articles of incorporation and bylaws, the activities of SWIMC and DIMC are confined to the maintenance and protection of their intangible investments and, therefore, they qualify for exemption from Delaware corporation income tax. Petitioner assigned trademarks to SWIMC and DIMC in exchange for stock in both corporations. Petitioner did not recognize any gain on those exchanges pursuant to IRC § 351. SWIMC and DIMC licensed those trademarks back to petitioner on a non-exclusive basis.

The Division maintains that SWIMC and DIMC served no legitimate business purpose and that the corporations were formed solely as a means to avoid taxation. Petitioner strongly disagrees that they were formed merely for tax avoidance but does acknowledge that business and financial planning requires that the issue of taxes be considered.

In ***Frank Lyon Co. v. United States*** (435 US 561, 55 L Ed 2d 550), the court set forth a two prong test in order to determine whether transactions between controlled corporations will be respected. The first prong is to establish whether the transactions were accomplished for a valid business purpose. The second prong of the test is to determine whether the transaction had economic substance. "The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction" while the economic substance inquiry "requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits" (***Rice's Toyota World v. Commissioner***, 752 F2d 89, 85-1 USTC ¶ 9,123, at 87,094, 87,096).

The resolution of this case involves an analysis and understanding concerning the nature of trademarks. The underlying proposition presented by Sherwin-Williams is that the transfer of these Marks and the license-back of them was accomplished for valid business reasons. It is this assumption with which we disagree and, thus, our conclusions herein with respect to the transactions having no economic substance or valid business purpose are based upon our finding that the transactions were inherently illogical and not rational from a business or economic standpoint.

It is well established that a transaction is to be taxed according to its substance and not its form. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding" (***Helvering v. Lazarus & Co.***, 308 US 252, 255). In reviewing the record in this matter, we conclude that there was no business purpose for the creation of these subsidiaries other than mere tax avoidance. The facts of this case demonstrate that Sherwin-Williams was performing all the functions that

SWIMC and DIMC were authorized to perform. Instead of the subsidiaries conducting any of the activities regarding the Marks, they have engaged Sherwin-Williams as their trademark service provider. Thus, it is apparent to us that the functions of Sherwin-Williams have not changed after the transactions creating the assignment and license-back of the Marks. Therefore, the only obvious benefit that we can see here is that petitioner was able to successfully avoid taxes that it would otherwise have to pay prior to the assignment and license-back transaction. There has been no other non-tax benefit realized.

In reviewing the business plan set forth in exhibit “J,” Sherwin-Williams set forth eleven objectives for the formation of SWIMC and DIMC. However, most of the objectives were unattainable or outright illogical based upon the operations of Sherwin-Williams. Here, we believe the Administrative Law Judge erred in accepting the proposed business objectives without independently verifying the plausibility of them.

From an economic perspective, trademarks play a role in the process of product differentiation, a process that assists a company in distinguishing its products from those of competitors in an effort to generate a profit level that exceeds the average profit for companies engaged in the same business. The role that a trademark performs in this regard is to convert the product into a branded product. As explained by Dr. Shapiro, a trademark is a signal which connotes a certain package of features and qualities at a particular price which enhances the ability to sell certain goods and earn an above-average rate of return. In other words, to earn a return above the cost of capital which Dr. Shapiro defined as the required return on capital that is based on what investors could expect to earn elsewhere in the economy on investments with the same risk. If the return on capital is less than the cost of capital, the transaction involved would be considered to be destroying value.

According to Dr. Shapiro, the trademark, standing alone, has no intrinsic value. Its value is based upon its recognition of representing the quality and services associated with products bearing the trademark. These attributes are supplied by the trademark owner's other intangible assets such as its organizational capital, which includes marketing and advertising capabilities. In order to realize a value from its trademarked products, a company needs such other intangible assets which enable the company to provide the quality features sought by customers in a cost-effective way. The profits earned on branded products are directly related to the amount of other intangible assets that the company is using.

Dr. Shapiro explained that a name becomes a branded product when customers associate it with a set of intangible and tangible benefits which are referred to as the product's brand value proposition which represents the core promises or values associated with the brand that are what customers expect when they see a particular company's product.

It is the understanding of this brand value proposition which is critical in order to set quality control standards as well as ensuring that your product is keeping up with changing customer tastes and other competitors' products.

In order to successfully establish a brand value proposition and manage the branded products, Dr. Shapiro explained that:

> you require marketing skills. You have to be able to identify customer desires. You have to be able to identify the trade-offs that customers are willing to make; both the physical trade-offs, this quality versus that quality, the economic trade-offs, more of this at a higher cost, and consequently higher price. So you need

> to be able to weigh those. It is a matter of skill, but also, critically, it's a matter of experience. You need a lot of knowledge.
>
> You have to also understand what the company is capable of delivering . . . and then you have to understand the company's sales channels (Hearing tr., pp. 3231-3232).

The facts of this case indicate that Dr. Puglisi was hired as a part-time employee to run both subsidiaries despite being employed as a full professor, owner of his own consulting firm and director of several other corporations. Furthermore, it is undisputed that at the time of his selection, Dr. Puglisi had no trademark experience, no experience in managing a branded product and no experience in the paint industry whatsoever. In fact, in his own testimony, it was clear that he was not familiar with many of the details concerning the actual trademarks.

Dr. Puglisi also was an officer of both SWIMC and DIMC. The other officers were Mr. Gordon Stewart and Mr. Michael Semes. Neither Mr. Stewart nor Mr. Semes had any trademark experience or any experience with Sherwin-Williams. Both men were attorneys.

As set forth above, Dr. Puglisi maintained each company's books, paid the bills, responded to all correspondence and telephone calls and prepared the monthly and quarterly financial statements that were presented to SWIMC's and DIMC's directors at the quarterly board meetings. He had check signing authority limited to $ 2,000.00 and Mr. Stewart had the same authority. Amounts in excess of $ 2,000.00 required the approval of one of the directors directly affiliated with petitioner.

The licensing agreements in the record indicate that SWIMC and DIMC were given substantial rights and responsibilities with respect to the Marks. The rights included decision-making authority with regard to the products on which the Marks could be used and with regard to the continued use of the Marks, approval authority as to advertising, responsibilities relative to quality control and third-party licensing and a decision-making role with respect to trademark litigation. Based upon the testimony of Dr. Shapiro, the employees of the subsidiaries would have no knowledge upon which to base any decisions made with respect to the use of the Marks.

The Administrative Law Judge had concluded that the creation of SWIMC and DIMC to manage the Marks would alleviate the alleged mark-management problems that petitioner had been experiencing. The Administrative Law Judge also determined that there were additional benefits in forming the subsidiaries such as: the benefit of incorporating in Delaware, the ability to use SWIMC and DIMC as possible shields should a hostile takeover attempt ensue, the ability to use SWIMC and DIMC as investment and financing vehicles, tax considerations, the ability to insulate the Marks from liabilities of petitioner, to increase the focus on third-party licensing and limiting petitioner's liability with regard to third-party licenses.

However, as set forth in the facts above, these benefits as outlined by the Administrative Law Judge and the business plan were not achievable. We have found that the hostile takeover defense has no merit, that Sherwin-Williams was prohibited from using the assets of SWIMC and DIMC as security for financing purposes and there was no focus on third-party licensing. Accordingly, the remaining benefits are mere tax avoidance.

We agree with the analysis of Dr. Shapiro that there would be serious economic risk in any business arrangement which separates the responsibility for trademarks and brand management from those in a company who work with the branded products on a daily basis and have actual knowledge of the brands, customer requirements, customer expectations and corporate capabilities. Decisions about how the trademarks should be used, whether they should be extended to new products, licensed to third-parties or whether the quality of the products on which they are used is sufficient, require on-going knowledge of the business in which the trademarks are used to sell products.

Therefore, we conclude that the form of this transaction does not match the substance since the purpose for creating the subsidiaries was a tax avoidance tool and there is absolutely no economic substance to the transactions since the many objectives in the business plan were wholly unattainable, the evidence failed to establish the pursuit of any of the proposed business plans following the creation of SWIMC and DIMC and there was not any economic benefit to be derived.

We next turn our attention to the AAA appraisal report and whether such report establishes that the royalty rates paid by petitioner to SWIMC and DIMC were at arm's length. The Administrative Law Judge in her determination summarily rejected the Division's arguments and accepted the report. Our analysis reaches an opposite result.

Primarily, we note that the record indicates that the use of applying the profit split rule of thumb to operating profits rather than petitioner's residual profits results in inflated royalty rates. Proof of this point is demonstrated by Dr. Shapiro's cost of capital analysis and his overlay analysis.[34]

In reviewing exhibit "M," the cost of capital analysis is conducted in order to establish whether Sherwin-Williams could have afforded to pay the royalty rates set by AAA's application of the 25%-33 1/3% split to its operating profit for the year in question, 1991, and the two preceding years. The report concludes that Sherwin-Williams would be unable to achieve its cost of capital. An example set forth in exhibit "M" (***see***, pp. 20-22) demonstrates that using a

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[34]Although AAA conducted an overlay analysis, the record in this matter contains only the simple statement that such analysis confirmed that the royalty rates were reasonable.

33 1/3% split applied to operating profit would have left petitioner earning over two percentage points less than its cost of capital for each of the years 1989 through 1991. Since a company must earn a profit in order to cover its cost of capital to remain viable, we conclude that the royalty rates set by the AAA appraisal were too high and, thus, unreasonable.

Dr. Shapiro also concluded that the valuation of the Marks was too high. The Administrative Law Judge disagreed stating that she was not convinced by his opinion that trademarks account for only a fraction of the intangible assets of a corporation. We reject this premise made by the Administrative Law Judge.

As stated in exhibit “M”:

> the income earned on a trademarked product increases with the amount of organizational capital supporting that mark. Hence, trademarks and organizational assets are synergistic - each enhances the value of the other. Thus, any analysis that ignores a company’s organizational assets will overvalue its trademarks - and that overvaluation will be in direct proportion to the amount of its organizational assets (exhibit “M,” p. 6).

Thus, we conclude that other intangible assets such as multiple distribution channels, ability to maintain quality control and the ability to adapt to a changing marketplace comprise the total intangible assets of a corporation.

In his report, Dr. Shapiro discounted the royalty income streams using the royalty rates set by AAA and also by a corrected discount rate that he computed. His analysis determined that the present value of the trademarks using AAA’s royalty rates was more than $658 million which resulted in representing 76% of the total value of Sherwin-Williams’ intangible assets. We agree with his conclusion that this percentage is extremely exorbitant in light of the fact that other intangible assets such as multiple distribution channels, ability to maintain quality control and the ability to adapt to a changing marketplace would only be represented by a mere 24% of petitioner's intangible assets.

We also find serious flaws with respect to the Grant Thornton transfer pricing report. We begin by focusing our attention on the comparables. As we stated in ***Matter of Tropicana Prods. Sales*** (Tax Appeals Tribunal, June 12, 2000): "[c]learly, if comparables are not carefully chosen, no adjustments or statistical methodologies will form a basis for accepting the expert's report as indicative of arm's length pricing."

In its report, Grant Thornton utilized the CPM which "evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances" (Treas Reg § 1.482-5[a]). An arm's-length result is determined by the amount of operating profit that the tested party would have earned on the controlled transaction if its profit level indicators were equal to that of an uncontrolled comparable (***see***, Treas Reg § 1.482-5[b][1]).

The CPM requires a selection of comparable uncontrolled transactions or entities. The regulations set forth the factors which affect comparability under a particular method to include: functions, contractual terms, risks, economic conditions and property or services (Treas Reg § 1.482-1[d]). The criteria for the selection of comparables is as follows:

> Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of

> the results. . . . The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range (Treas Reg § 1.482-1[e][2][ii]).

The regulations at section 1.482-5(c) set forth the degree of comparability required under the CPM. The CPM "compares the profitability of the tested party, measured by a profit level indicator (generally based on operating profit) to the profitability of uncontrolled taxpayers in similar circumstances" (Treas Reg § 1.482-5[c][2][i]). Comparability under the CPM "is particularly dependent on resources employed and risks assumed" (Treas Reg § 1.482-5[c][2][ii]). The degree of functional comparability required to obtain a reliable result under the CPM is "generally less than that required under the resale price or cost plus methods" (Treas Reg § 1.482-5[c][2][ii]). The CPM is not as dependent on product similarity as the resale price of cost plus method "because operating profit usually is less sensitive than gross profit to product differences" (Treas Reg § 1.482-5[c][2][iii]).

Once comparables are selected, the CPM provides that if there are differences between the tested party and the comparables that would materially affect the profits determined under the PLI, adjustments should be made. Such adjustments include adjusting the operating profits for differences in inventory, accounts receivable and accounts payable (***see***, Treas Reg § 1.482-5[c][2][iv]). The arm's-length range will consist of the financial results of all the uncontrolled comparables if all material differences between the tested party and the uncontrolled comparables have been identified and adjustments have been made to eliminate the effect on each such difference (***see***, Treas Reg § 1.482-1[e][2][iii][A]).

In this case, Mr. Hasenwinkle testified that he specifically excluded from his selection of comparables, companies with significant intangibles.[35] The reasoning for excluding this group of companies was because Sherwin-Williams does not engage in extensive R & D and marketing and promotion activities and, as a result, does not assume the risks associated with these functions. As set forth in the facts above, this search strategy effectively excludes high-profit companies because the expected profits of those companies would be greater because of the inclusion of those intangibles. Thus, the weeding out of these more profitable companies with the highest PLIs will directly result in pushing down the interquartile range. Moreover, based upon our conclusions, it cannot be disputed that Sherwin-Williams has valuable intangibles. Therefore, the decision to exclude companies with significant intangibles renders the report invalid.

Another example of choosing incompatible comparables is reflected in Grant Thornton's claim that the most narrowly defined business activity rule justified its decision to perform separate CPM analyses with respect to Sherwin-Williams' manufacturing divisions. Yet, the comparables chosen were diversified companies which manufactured a variety of products other than coatings. As set forth in the facts, one of the comparables, PPG is one of the major producers of flat glass, fabricated glass and continuous strand fiber glass in the world with approximately 39% of its net sales coming from the production of glass in 1991. Instead of using the financial information from the segment of the diversified alleged comparables that most closely paralleled the activities of the specific Sherwin-Williams' division in question,

[35] In fact, the actual method employed by Grant Thornton in arriving in its decision to choose comparables has not been adequately explained.

Grant Thornton used the diversified comparable's consolidated financial results from all of its operations.

Moreover, the CPM for the Automotive Division is flawed since Mr. Hasenwinkle incorrectly assumed that this division did not have any retail outlets when, in fact, it has 154 stores. The Grant Thornton report discusses this division's sales channels and end markets. The report mistakenly notes that the sales channels are mainly wholesale. This misunderstanding of the retail functions of the Automotive Division severely undermines the comparables chosen for this division.

We have held that once the presumption of distortion arises, the burden of proof falls upon the taxpayer to overcome such presumption by establishing that separate reporting would result in the proper reflection of income. We conclude that petitioner has failed to rebut the presumption of distortion. Therefore, the Division properly required Sherwin-Williams to file a combined report with SWIMC and DIMC for the year in issue.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted;

2. The determination of the Administrative Law Judge is reversed;

3. The petition of Sherwin-Williams is denied; and

4. The Notice of Deficiency, L-013066163, dated January 13, 1997 is sustained.

DATED: Troy, New York
June 5, 2003

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner