STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition

of

THE TALBOTS, INC.

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1994, 1995 and 1996.

DETERMINATION
DTA NO. 820168

Petitioner, The Talbots, Inc., 178 Beal Street, Hingham, Massachusetts 02043, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1994, 1995 and 1996.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, commencing on December 5, 2005 at 10:30 A.M. and continuing daily thereafter to conclusion on December 8, 2005, with all briefs to be submitted by June 23, 2006, which date commenced the six-month period for issuance of this determination (Tax Law § 2010[3]). The six-month period was extended for an additional three months pursuant to 20 NYCRR 3000.15(e)(1). Petitioner appeared by Brann and Isaacson, Esqs. (Martin I. Eisenstein, Esq., and David Swetnam-Burland, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Nicholas A. Behuniak, Esq., and Jennifer L. Baldwin, Esq., of counsel).

ISSUE

Whether the Division of Taxation may properly require petitioner, The Talbots, Inc. ("Talbots"), to file its New York State Corporation Franchise Tax Report on a combined basis to include its wholly-owned subsidiary, The Classics Chicago, Inc. ("Classics"), because Classics does not have sufficient economic substance on its own or because Talbots did not meet its burden of establishing the appropriateness of the royalty charged Talbots by Classics for the use of certain trademarks.

FINDINGS OF FACT

1. Pursuant to section 3000.15(d)(6) of the Rules of Practice and Procedure of the Tax Appeals Tribunal and section 307(1) of the State Administrative Procedure Act, both parties submitted proposed findings of fact. Talbots has submitted 294 proposed findings of fact, and the Division of Taxation has submitted 226 proposed findings of fact. The proposed findings of fact have been substantially incorporated into this Determination with the exception of those noted in the final two Findings of Fact.

Procedural Background

2. The Division of Taxation ("Division") conducted an audit of the corporate franchise tax returns of Talbots for the fiscal years ended January 28, 1995 ("FY 1994"), February 3, 1996 ("FY 1995") and February 1, 1997 ("FY 1996"), collectively referred to as the "audit period." As a result of its audit, the Division issued to Talbots six notices of deficiency, each dated December 14, 2001, asserting additional corporation franchise tax due for the audit period.[1]

[1] The notices issued bore assessment numbers L-020655778, L-020627000, L-020627001, L-0206027002, L-020627003 and L-020627004.

Both during the course of the audit, and after the notices of deficiency were issued, Talbots responded to numerous requests for information ("information document requests" or "IDR's"), and later subpoenas issued by the Division, with respect to Talbots, experts used by Talbots, and Classics.

3. Talbot's challenged the notices by requesting a conciliation conference with the Division's Bureau of Conciliation and Mediation Services ("BCMS"). A conciliation conference was held on August 13, 2002 and, pursuant to a Conciliation Order issued June 18, 2004, the notices of deficiency numbered L-020627001 and L-020627002 were cancelled in full and the remaining four notices of deficiency were sustained, such that the remaining amount of tax at issue after the conciliation conference totaled $236,314.00, plus penalties (imposed on the notices numbered L-020627003 and L-020627004), and interest.

4. Talbots continued its challenge by filing a timely petition with the Division of Tax Appeals regarding the four notices of deficiency remaining in issue. As set forth in the petition, as amended, and in the Division's answer thereto, as amended, Talbots challenged two elements of the notices of deficiency: (1) corporate franchise tax asserted against Talbots based on the Division's combination of the income of Talbots and Classics for purposes of calculating the tax owed by Talbots and, (2) corporate franchise tax asserted against Talbots based on the Division's combination of the income of Talbots and a second Talbots subsidiary, Talbots International Retailing, Ltd. ("Talbots International"), for purposes of calculating the tax owed by Talbots.

5. Prior to the hearing held in this matter, Talbots and the Division settled their dispute concerning the amount of tax assessed as a result of the combination of Talbots and Talbots International. Accordingly, it is only the combination of the income of Talbots and Classics which remains at issue in this matter, with the parties stipulating that the amount of tax

remaining at issue is $167,951.00, plus penalty (as imposed only for FY 1996) and interest. The evidentiary record at hearing consists of the Talbots' exhibits numbered "1" through "31", the Division's exhibits lettered "A" through "GG" (including the parties' joint exhibit "J", but excluding letters "U" and "V"), the testimony of Talbots' witnesses Edward Larsen, Maureen Grady, Steven Cohen and Sharon Voorheis, and of Talbots' expert witness Robert Reilly, the testimony of the Division's witnesses Mark Tomeck and Richard Mayer, and of the Division's expert witness Dr. Ednardo Silva, and the rebuttal testimony of Talbots' expert witness Robert Reilly.

The History of Talbots

6. Talbots is a Delaware corporation with its principal place of business located before, during, and after the audit period at 175 Beal Street, Hingham, Massachusetts. Talbots is a vertically integrated, leading specialty retailer and cataloger of women's classic apparel, accessories, and shoes. The first Talbots retail store opened in Hingham, Massachusetts in 1947, and the first Talbots catalog was issued the next year.

7. Talbots continued in business from its founding, and was eventually acquired by General Mills, Inc. in 1973. Thereafter, JUSCO (U.S.A.), Inc. ("Jusco USA") acquired Talbots from General Mills in June 1988. During the time that it owned Talbots, Jusco USA was a wholly-owned subsidiary of JUSCO Co. Ltd. ("Jusco Ltd."), a Japanese corporation.

8. As of June 26, 1988, all trademarks, tradenames, service marks, designs, corporate names, logos, brand marks, and brand names in the United States and abroad relating to the Talbots name and brand (collectively, the "Talbots worldwide trademarks") were owned by a holding company known as JUSCO (Europe) B.V. ("Jusco BV"), a Dutch corporation with its principal place of business at Geleen, the Netherlands. The only documented purpose for which

the Talbots worldwide trademarks were originally separated from Talbots in 1988 and transferred to Jusco BV, was to "provide optimal economics (i.e., significant tax savings)" (***see,*** Finding of Fact "18"). According to testimony at hearing, Jusco BV assumed ownership of the Talbots worldwide trademarks for the following three reasons:

> (a) the accounting advantage to Jusco Ltd. based on the treatment of the amortization of intangibles in the Netherlands (pursuant to which Jusco Ltd's financial statement income would not be decreased since amortization would not be required for intangibles held by a Dutch corporation);
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> (b) the (U.S.) Federal tax advantage of allowing Jusco USA to deduct the royalty payments to Jusco BV on its United States federal tax returns while the Netherlands company (Jusco BV) paid tax on the royalty income at a (relatively) lower rate; and
>
> (c) the business advantage of creating greater flexibility in the exploitation of the Talbots trademarks outside of the United States. In this respect, Jusco Ltd. entered into a separate agreement with Jusco BV for use of the Talbots trademarks in Japan, in part as the result of the greater flexibility allowed by the holding of the Talbots worldwide trademarks by a Dutch corporation.

Talbots' witness did not discuss (or dispute) that the tax advantage of the deduction for royalty payments would likewise be available at the state level, but stated in this regard that "we did not focus on state tax when we did this . . . [i]f it came up, it came up as a side issue."

9. Jusco BV financed its purchase of the Talbots worldwide trademarks primarily through a loan from Jusco Ltd., plus some third-party (bank loan) financing. Jusco BV paid Jusco Ltd. interest on that loan.

10. On June 26, 1988, Jusco BV and Talbots executed the 1988 License, pursuant to which Talbots obtained the right to use the Talbots worldwide trademarks in exchange for royalty payments at rates set out pursuant to such license agreement and the exhibits attached thereto. The 1988 License provided that the royalty rates would be as follows:

YEAR (years ended 05/31/89 and each year thereafter)	ROYALTY RATE	ESTIMATED ANNUAL NET SALES	ESTIMATED ANNUAL ROYALTY PAYMENT
FYE 05/31/89	2%	$411,000,000	$8,220,000
FYE 05/31/90	1.9%	$499,000,000	$9,481,000
FYE 05/31/91	1.8%	$595,000,000	$12,474,000
FYE 05/31/92	1.7%	$693,000,000	$11,781,000
FYE 05/31/93	1.6%	$785,000,000	$12,560,000

The royalty rate for years after Year "5" (FYE 05/31/94 and fiscal years thereafter) was to remain constant at the rate applicable to Year "5" (i.e., 1.6% of estimated net sales). However, the 1988 License provided that "In the event that Net Sales in any year shall vary materially from 'Estimated Annual Sales', as set forth in [the 1988 License], Licensor and Licensee shall consult with each other in good faith so as to adjust the Royalties payable hereunder to more nearly reflect their expectations under [the 1988 License]." The original term of the 1988 License was five years, with automatic one-year renewals that provided a six-month cancellation option.[2]

11. Paragraph "2" of the 1988 License, entitled "Quality Standards" provided as follows:

> Quality Standards. Licensor seeks to ensure, and Licensee undertakes to maintain, the highest standards of quality with respect to all goods and services of Licensee utilizing the Licensed Marks, and to this end:
>
> (a) Licensee shall manufacture, sell, distribute and promote all goods utilizing the Licensed Marks, and shall provide all services utilizing the Licensed Marks, at all times during the term hereof in accordance with all applicable laws and regulations, and all such goods and services shall meet such standards of style, appearance and quality so as to exploit to the best advantage, protect and enhance the Licensed Marks and the Goodwill.

[2] For FYE 05/31/92 and FYE 05/31/93, Talbots paid Jusco BV royalties at the rate of 1.8% of net sales (as opposed to 1.7% and 1.6%, respectively, of Talbots' estimated annual net sales for such fiscal years).

(b) Licensor and/or its duly authorized representatives shall have access during all reasonable business hours to the places where the goods are manufactured, stored, sold, distributed or promoted by Licensee using the Licensed Marks, or where any services utilizing the Licensed Marks are provided, and Licensor shall have the right to take, without charge, a reasonable number of samples of any such goods or to evaluate in detail, through any reasonable means, any such services in order that Licensor may verify and assure itself that such goods or services meets Licensor's quality standards.

(c) Licensee shall furnish to Licensor, upon Licensor's request, details of the design and manufacture of all goods to be sold utilizing the Licensed Marks, and detail of design of store layouts, signs, advertising, promotion materials, or any other service usage utilizing the Licensed Marks, and shall upon Licensor's request notify Licensor of any proposed changes in any such designs and manufacturing prior to the adoption thereof.

(d) Licensee shall submit to Licensor for its written approval (or if written approval is not received [by telefax or otherwise] within 7 days, upon the expiration of such period) before any use is made thereof, copies of catalogues of Licensee's goods and upon request of the Licensor, a reasonable number of samples of packaging, labeling, advertising or promotional materials on which the Licensed Marks appear. Licensee, upon the request of Licensor, shall indicate in or on such packaging, labels, advertising or promotional materials that the Licensed Marks are being used by Licensee under license from Licensor in a legend approved by Licensor.

(e) All rights to the copyrights in the labeling, packaging, advertising and promotional materials used in connection with the Licensed Marks shall at all times be owned by Licensor. Should Licensee ever acquire any right to such copyrights during or after the life of this Agreement, Licensee shall assign and does hereby agree to assign to Licensor all such rights.

(f) (1) Licensee shall annually develop a marketing plan (hereinafter the "Marketing Plan") for its goods and services utilizing the Licensed Marks, which shall include such matter as, but shall not be limited to:

(a) Problems, opportunities and risk identification;

(b) Sales and store opening objectives by state, size and type;

(c) basic/general brand strategy to achieve objectives;

(d) Pricing strategies;

(e) Positioning, detailing brand distinctiveness and personality;

(f) Consumer target groups, expressed in demographic terms;

(g) Strategy, plans and spending levels for advertising, merchandising and promotions;

(h) Personnel hiring standards and objectives and training programs for personnel;

(I) Market research and spending levels; and

(j) Implementation schedules.

(2) Licensor shall have the right to review and approve the Marketing Plan or any strategic deviations therefrom, in a timely manner prior to implementation thereof;

(3) Following implementation of the marketing plan, Licensor shall have the right to veto executions of the Marketing Plan which are not in keeping with the originally approved strategies. The reasons for any such veto made must be reasonable and not arbitrary, and shall be detailed in writing and given to Licensee. Within 30 days of such a veto, Licensee shall be required either to cancel the execution or to adopt an execution acceptable to Licensor.

(4) Licensee shall review with Licensor from time to time, as Licensor shall consider appropriate, the results and trends of the Marketing Plan elements referred to Section 2(f)(1) hereof, the administration of this Agreement and any other factors affecting goods or services utilizing the Licensed Marks.

(5) Licensee shall provide to Licensor upon Licensor's request all information related to this Agreement that affects goods or services utilizing the Licensed Marks, including but not limited to marketing plans, financial and marketing information, sales results, market research data and other information related to the development of the goods, services and Licensed Marks. However, Licensee shall not be required to provide information to Licensor that would violate any confidentiality agreement with a third party or would violate any federal, state or local law.

(g) Licensee shall notify Licensor of its intention to introduce new goods and services, other than those already manufactured and sold, or provided, by Licensee at the time of making this Agreement, in connection with which Licensee proposes to utilize the License Marks. For goods and

> services not yet marketed, Licensee shall submit to Licensor at Licensor's request a reasonable number of samples of such goods or details of such services.

12. Jusco BV's primary business was to act as a holding company for the Talbots worldwide trademarks. The decision-makers at Jusco BV were executives of Jusco Ltd. Jusco BV contracted with two individuals who were full-time employees of a British bank to provide services to Jusco BV on a part-time basis, primarily to manage the Talbots worldwide trademarks. Jusco BV did not own any property, real estate, or office space, but rather rented shared office space in the Netherlands and in the United Kingdom. Jusco BV was not involved in any of the operations of Talbots, e.g., product sourcing, product design, or customer acquisition, in any capacity.

The History of Classics

13. On November 18, 1993, Talbots effected an initial public stock offering ("IPO") of its common stock. At the time of the IPO, Jusco USA, the wholly-owned subsidiary of Jusco, Ltd., retained 63.4% of the outstanding common stock of Talbots.[3]

14. Classics, a wholly-owned subsidiary of Talbots, is a Delaware corporation with its principal place of business located in Chicago, Illinois. At the time of its incorporation on October 20, 1993, and during the audit period, Classics' board of directors consisted of Arnold B. Zetcher, Talbots' chief executive officer, Richard T. O'Connell, Jr., Talbots' senior vice-president for real estate, and Suzanne Saxman, an attorney with the firm of D'Ancona and Pflaum, who had no employment affiliation with Talbots.

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[3] Jusco USA continues to own, after dilution due to management stock option exercise, approximately 58% of Talbots' outstanding common stock.

During the audit period, Classics' officers included Arnold B. Zetcher (president), Edward L. Larsen (vice-president and treasurer), Richard T. O'Connell, Jr. (vice-president and secretary), Sandy F. Katz (assistant treasurer), John Florio (assistant secretary), and Suzanne C. Saxman, Esq. (assistant treasurer). None of Classics' officers were paid any compensation by Classics for serving in such capacity. Neither Mr. O'Connell nor Ms. Saxman was ever a member of the board of directors of Talbots. Edward L. Larsen, Sandy F. Katz, and John Florio held the titles, respectively, of Talbots' senior vice-president and treasurer, Talbots' vice-president, and Talbots' assistant secretary. The record does not disclose whether Edward L. Larsen, Sandy F. Katz, or John Florio were ever members of Talbots' board of directors.

15. Classics does not have any employees of its own, but rather contracted with two individuals on a part-time basis, to wit, Ms. Saxman to "run Classics' business operations" and Maureen Doyle to perform its bookkeeping and accounting duties. More specifically, Ms. Saxman approved major expenditures, handled wire transfers of funds, had bank account signatory authority, reviewed bookkeeping matters and handled other matters as required by Classics' board of directors. Concurrent with performing her duties for Classics, Ms. Saxman worked for the law firm of D'Ancona & Pfluam. Ms. Doyle prepared invoices, reconciled bank accounts, prepared monthly accounting statements and handled day-to-day activities. Neither Ms. Saxman nor Ms. Doyle testified at the hearing. Classics also retained outside trademark counsel to be available to handle trademark applications, trademark registration renewals, infringement investigations, and infringement litigation in the event there was any. The record provides no detail of any such work which was, or may have been, performed by outside trademark counsel, nor any specific information as to how Classics enhanced or otherwise "managed" the trademarks, or ever monitored or assured trademark legal compliance.

16. Classics has never obtained any third-party financing, or entered into any independent third-party licensing arrangements, including licensing limited geographic rights, for the Talbots trademarks. It has never performed any quality control work with regard to the Talbots trademarks, nor performed any product research or development or product manufacturing, product distribution, store development, or catalog creation or mailing. Classics has never gathered or maintained any customer lists or information pertaining thereto, or sold any branded products. Classics paid no advertising expenses during or prior to the audit period. However, after the audit period at issue herein Classics paid the retainer fee, as distinguished from the costs of the actual advertisements, of the advertising agency that develops and produces advertising for the Talbots brand. Classics does not own any real property or lease any real property from third parties, but does sublease a small (approximately 200 square feet) office space from Talbots.

17. It was deemed critical to the successful marketing of the IPO that Talbots own or control substantial rights in the Talbots trademarks. Accordingly, just before the Talbots' IPO, and on the advice of the investment bankers and corporate attorneys counseling Jusco Ltd. and Jusco USA regarding the Talbots IPO, Classics took ownership from Jusco BV of the Talbots worldwide trademarks throughout all regions of the world except for certain geographic areas commonly referred to as the Asian territories.

18. Classics paid approximately $103,000,000.00 for the Talbots trademarks, primarily using money it obtained from Talbots via a $102,000,000.00 loan evidenced by a promissory note for such amount from Classics to Talbots bearing interest at the rate of 4.83% compounded

quarterly.[4] The investment bankers and corporate attorneys handling the Talbots IPO believed that placing ownership of the Talbots trademarks in the control of a domestic intellectual property holding company owned by Talbots would maximize the value of Talbots stock at the time of the IPO. Specifically, a general consensus was reached among Talbots' management team, the investment firm (Merrill Lynch), accounting firm (Deloitte & Touche), and the legal advisers (Sullivan & Cromwell and Fried Frank, et al) involved with the Talbots' IPO, that the Talbots trademarks would be transferred to Classics in order to "minimize state and local taxes" and to "facilitate any future sale of Talbots, by Jusco, without disrupting the trademark purchase structure recommended."

19. The record includes a document dated July 9, 1993 entitled "Presentation to Jusco Co. Ltd. 'Structure of Sale of Trademark Rights to the Classic'" (the "July 9th Presentation Document"),[5] prepared in connection with the IPO of Talbot's stock. The "Objective" of the transfer of the Talbots trademarks was set forth in the following terms:

> *Objective*: As previously discussed, it is critical to the successful marketing of an IPO of the Classic to have the Classic *own or control* substantial rights in the Classic trademark. *The Classic trademark was separated from the Classic at the time of the original acquisition by Jusco in order to provide optimal economics (i.e., significant tax savings).* It is now imperative to put the Classic trademark back into the Classic in the most economically advantageous structure available.
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> At this time, we will not reiterate the marketing issues associated with the Classic acquiring an interest in the trademark *as these have already been discussed in great detail*. (Emphasis added.)

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[4] The promissory note was signed by Edward L. Larsen, followed by his title with Talbots (senior vice-president and chief financial officer), as opposed to his title with Classics (vice-president and treasurer). Mr. Larsen noted in testimony that, as is frequently the case, he was not the person who affixed his titles to the note. The manner in which these titles are reflected on the note have remained unchanged.

[5] The name "the Classic" in such document is a reference to petitioner, Talbots.

The "Background Logic" and "Components" underlying the "Structure" of the transaction were set forth (in relevant part) in the following terms:

> Background Logic: Structure transaction in the most economically advantageous manner for the Classic in order to maximize the value to the Classic, and therefore maximize value for its shareholders.
>
> Components: (1) Sell significant rights to the Classic, while retaining significant rights in Jusco Europe. This will allow the asset purchased by the Classic to be tax deductible (over 25 years or possibly as low as 14 years [in whole or in part] under proposed tax law changes), and thus create federal tax savings of approximately $1.4 million per year.
>
> (2) The purchaser will be a new wholly-owned subsidiary of the Classic that will be incorporated in Delaware and have its principal business office in Illinois. This new subsidiary will provide two benefits to the Classic:
>
> (a) Minimize state and local income taxes–additional savings of $150,000 - $200,000 per year.
>
> (b) Facilitate any future sale of the Classic, if desired by Jusco, without disrupting the trademark purchase structure that we are recommending.

20. Talbots senior vice-president and chief financial officer, Edward Larsen, testified that he made the decision that Classics, rather than Talbots, would purchase the Talbots trademarks from Jusco BV.[6] According to Mr. Larsen, the decision was made for several reasons, including:

> (a) to provide Talbots, as a newly public company, the flexibility to grow the business both geographically and through the establishment of new product lines;
>
> (b) to provide Talbots the ability to sell geographical rights to the Talbots trademarks to other business ventures;

[6] The clear implication from the words of Mr. Larsen's testimony was that he alone made the decision to utilize the subsidiary Classics to purchase the Talbot's trademarks. This must be contrasted with the description that a "consensus" was reached between Talbot's "management team" (presumably including Mr. Larsen) and the bankers, accountants and attorneys involved.

> (c) to create a captive revenue stream of royalty payments into Classics that could be used as collateral for loans from institutional lenders.

In this latter regard, Talbots management believed that Talbots might need the ability to obtain loans secured separately by the stream of royalty payments to Classics. Mr. Larsen noted that this method of having an identified captive revenue stream from royalty payments was a useful means of securing financing and was something he was accustomed to based on his period of employment, years earlier, with General Mills, Inc. Talbots' management was also allegedly uncertain as to whether the Japanese banks that had previously provided financing for Talbots via loans that had been backed by a guarantee from Jusco Ltd. would continue to provide financing to Talbots without such a guarantee from a Japanese business. In fact, such Japanese bank financing did continue after the transfer of the trademarks from Jusco BV into Classics.

21. Mr. Larsen further claimed that the decision to have Classics, as opposed to Talbots, purchase the Talbots trademarks from Jusco BV was not made for state tax reasons, and that state tax considerations played no role in that decision. Mr. Larsen stated that he did not ask Talbots' director of taxes, Maureen Grady, to determine whether any tax savings would result from the creation of Classics before making the decision that Classics would acquire the Talbots trademarks from Jusco BV, but rather made the request of Ms. Grady to determine the tax effects of the decision after it had been made. In turn, Ms. Grady explained that other, outside professionals had already (i.e., pretransfer and pre-IPO) analyzed the transaction and determined the estimated tax savings, and that Talbots' tax department did not determine how the transaction would be structured, never performed a pretransfer study to determine whether the acquisition of the Talbots trademarks by Classics would result in tax savings to Talbots, and noted her opinion that from a tax standpoint the ideal arrangement would have been not to transfer the trademarks from Jusco BV to Classics, but to have kept the trademarks with Jusco BV.

22. The record includes a series of interoffice memoranda and an accompanying tax analysis, authored by Ms. Grady and directed to Mr. Larsen, dated and titled as follows:

> (a) June 10, 1993 (i.e., one month prior to the July 9th Presentation Document described above) titled "Delaware Holding Company";
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> (b) August 17, 1993 titled "Comments on Incorporation of Talbots Chicago";
>
> (c) August 18, 1993 titled "Talbots Trademark Analysis"; and
>
> (d) August 20, 1993 titled "Establishing Subsidiary to Purchase Trademarks."

These memoranda and the tax analysis provide some insight into the matter at issue and are summarized hereinafter.

23. The June 10th memorandum discusses the benefits of organizing a new subsidiary corporation in Delaware to purchase the Talbots' trademarks, in contrast to the (then) current benefits of the Jusco BV trademark ownership structure. The memorandum points out, in part, that Talbots would pay a deductible (Federal and state) royalty to the new subsidiary which would report the royalty income. The royalty income (to the subsidiary) and expense (to Talbots) would offset in a consolidated Federal return, and since the subsidiary would file no state tax returns, Talbots would deduct the royalty expense for state tax purposes with no income offset. The subsidiary might be able to take an amortization deduction based on the cost of acquiring the trademarks. This June 10 memorandum goes on to discuss the importance of establishing the substance of the subsidiary for state tax purposes, including establishing an office in Delaware to which royalty payments could be mailed, retaining a part-time employee there to receive, record and deposit the payments, and retaining an attorney in Delaware to be available to handle trademark/trade name infringement issues if any arose. The memorandum points out that the Delaware subsidiary structure works well for Talbots International because

there is a bona fide office and operations for such corporation (Talbots International) in Hong Kong, that "it is easier to support the claim that the business is *not* run out of MA [i.e., Talbot's headquarters] if there is evidence that it *is* run from somewhere else" (emphasis in original), and rejects a suggestion to have Talbots International purchase the trademarks because it is important, for state tax purposes, to keep distinct "lines of business" separate.[7] The memorandum concludes that if it is not feasible to set up a new office in Delaware or offshore, then Talbots should consider operating the "royalty business" out of an existing office in a state having lower tax rates than exist in Massachusetts.

24. The August 17th memorandum discusses the recommended steps to segregate Talbots from Talbots Chicago, by first listing the characteristics that imply a unity in corporate operations, including centralized management, staff functions and purchasing, intercompany financing, substantial "flow of value" (products or services), exchange of "know-how," common identity seen in common name, trademark, goodwill, use of facilities and customers. Steps suggested to minimize the link between Talbots and Classics include not using the name Talbots for the subsidiary, and minimizing the number of members of Talbots' board of directors who would be members of Classics' board of directors. The memorandum goes on to note that Talbots "specifically established the location of the new corporation in Illinois to avoid taxation in Massachusetts and other non-unitary states." The August 17th memorandum concludes with the suggestion that a loan to the new corporation on arms-length terms in an amount sufficient to

[7] Talbots International was initially a part of this case due to the Division's position that Talbots International should be included in the filing of a combined franchise tax report with Talbots. The parties settled this part of their dispute prior to the hearing (***see*** Finding of Fact "5"). The particular terms upon which the settlement was reached were not disclosed as part of the record, although the settlement did result in a reduction to the amount of tax assessed.

fund the purchase of the trademarks, as opposed to a capital contribution in such an amount, should be considered in order to minimize the amount of Illinois tax on paid in capital.

25. The August 20th memorandum was written as a "follow up to the August 17th meeting," and after receiving additional input from the accountants and attorneys involved in the Talbots IPO. This memorandum reiterates that Delaware is the appropriate state for incorporation of the subsidiary, and that its operations "should be established in a Unitary State since they will tax the company's profits anyway, no matter how it is structured." This memorandum discusses the capital contribution (and attendant capital tax cost) versus loan financing to acquire the trademarks, observing that "[f]rom an operational standpoint, it makes more sense to set up an intercompany loan between Talbots and Trademark Sub. The subsidiary is not going to be able to use the large sums of cash it is going to receive as royalty payments. It will be easier to transfer the money as a payment on a note than as a dividend." The balance of the memorandum addresses the steps to be taken prior to incorporation, including having a person authorized to handle royalty receipts from and loan payments to Talbots, obtaining a convenient office location with a separate telephone number (and allocating some occupancy costs to the subsidiary if it is a Talbots shared location), establishing a board of directors with some members who are not also members of Talbots board of directors, and eliminating any reference to the Talbots name in the subsidiary's name. The memorandum concludes by stating that "[i]f we cannot give the new company the appearance of operating independently, the states will not view it as operating independently."

26. The August 18, 1993 tax analysis contrasts and illustrates the Federal and state tax benefit difference between placing ownership of the trademarks in Talbots versus placing ownership in a controlled subsidiary (including, in the subsidiary ownership structure, the tax

difference between having the subsidiary use capital versus debt to purchase the trademarks). The analysis assumed a trademark cost of $103 million, a 15-year amortization period, a royalty payment of $10,500,000.00 per year, and provided the following contrast in benefit:

Trademarks owned by Talbots:

Annual trademark amortization deduction	$6,866,667.00
(I) Federal (35%) and state (5.8%) tax benefit	2,801,600.00 (a)

-Versus-

Trademarks owned by subsidiary:

Trademarks owned by subsidiary	$103 million equity	$103 million debt
Royalty expense (deduction to Talbots)	$10,500,000.00	$10,500,000.00
State tax benefit to Talbots (at 5.8%)	609,000.00 (b)	609,000.00 (b)
Royalty income (income to subsidiary)	$10,500,000.00	$10,500,000.00
State tax expense (at .8% to subsidiary)	(84,000.00) (c)	(84,000.00) (c)
Trademark amortization deduction (to sub.)	6,866,667.00	6,866,677.00
Federal (35%) & state (.8%) tax benefit (to sub.)	2,458,267.00 (d)	2,458,267.00 (d)
Net tax benefit of using subsidiary (b) + (c) + (d)	2,983,267.00 (e)	2,983,267.00 (e)
Excess tax benefit of using subsidiary (a) vs. (e)	181,667.00	181,667.00
Illinois capital tax	(103,000.00)	0.00
Annual excess tax benefit	$ 78,667.00	$ 181,667.00

27. Before the sale of the Talbots trademarks to Classics, Talbots took a deduction on both its Federal income tax returns and its state income tax returns, including its New York State corporation franchise tax reports, for the royalties it paid to Jusco BV. After the sale, Talbots was not able to receive the benefit of a deduction on its Federal income tax returns for the royalty paid to Classics due to the filing of consolidated Federal income tax returns, but was able

to deduct the royalty on some of its state income tax returns, including its New York State corporation franchise tax reports.

28. The royalty rate that Talbots was to pay Classics was the same royalty rate (at least initially) that Talbots formerly paid to Jusco BV under the 1988 License, and thus Talbots obtained no increased New York State tax advantage from the transfer of the Talbots trademarks from Jusco BV to Classics. In fact, Talbots paid more state tax after Classics became the licensor of the Talbots trademarks (to Talbots) than when Jusco BV was the licensor of the Talbots trademarks (to Talbots), at least in part due to the fact that Classics is headquartered in Illinois as opposed to Delaware, its place of incorporation. Further, Talbots paid more Federal income tax after Classics became the licensor of the Talbots trademarks to Talbots because Classics is a corporation located in the United States.

29. On November 26, 1993, approximately one month after the October 20, 1993 incorporation of Classics, Classics and Talbots entered into a new license agreement, (the "1993 License"), under the terms of which Talbots obtained the right to use the Talbots trademarks in exchange for royalty payments to Classics. The 1993 License provided for royalty rates of 1.8% of net sales for the first five years, 1.7% of net sales for the following five years, and 1.6% of net sales thereafter. The 1993 License had an original term of five years, with automatic renewals thereafter. Upon termination of the 1993 License, Talbots would be required to immediately cease using the Talbots trademarks. Paragraph "2" of the 1993 License, entitled "Quality Standards" provided as follows:

> Licensor seeks to ensure, and each Licensee undertakes to maintain, the highest standards of quality with respect to all goods and services of each Licensee utilizing the Trademarks.

The subparagraphs (a) through (g), as contained in the 1988 License and specifying certain rights, powers and obligations between the parties, were not set forth or specifically included in the 1993 License (***compare*** Finding of Fact "11").

30. For FY 1994 (FYE 01/28/95) and FY 1995 (FYE 02/03/96), Talbots paid royalties to Classics at the same rate at which Talbots had paid Jusco BV for the years immediately preceding Classics' acquisition of the Talbots trademarks. For FY 1996 (FYE 02/01/97), the 1993 License, to which Talbots and Classics were still subject, was amended ("the Amended 1993 License") so as to extend its term and to adjust the royalty rate.[8] Under the terms of the Amended 1993 License, Talbots paid Classics a new, and higher, royalty rate of 6% of net sales for all quarterly periods on or after February 4, 1996. The Amended 1993 License extended the term of the 1993 License for an additional five years, to November 25, 1998. The adjustment in the royalty rate to 6% was made in response to the results of a study commissioned by Talbots to determine the appropriate arm's length royalty rate for the Amended 1993 License. That study was also commissioned in response to inquiries from a number of state tax authorities, including the Division, seeking confirmation of the arm's length nature of the royalty rate paid by Talbots to Classics. The minutes of the Talbots' November 6, 1996 board of directors' meeting reflect that a proposal to amend the 1993 License was presented by Edward L. Larsen, in which he reviewed the results of the study and its conclusion that the royalty rates established in the 1993 License "were now below competitive rates in light of the importance of the tradename/trademark to the business and profitability." There is no evidence of any study

[8] The decision to amend the 1993 License so as to increase the royalty rate was not formally made at one of Talbots' board of directors meetings, although the record reflects the topic of such increase was discussed at such a meeting held November 6, 1996 and was proposed for formal approval to occur by subsequent unanimous written consent.

undertaken or completed by which the royalty rates under the 1988 License were established or to support the initial use of the 1.8% royalty rate in the 1993 License. The increase in the royalty rate to 6% made the trademark royalty expense Talbots' third largest annual expense behind its cost of goods sold expense and its compensation expense.

The Willamette Study

31. The valuation study commissioned by Talbots was performed by Willamette Management Associates ("Willamette"), a firm specializing in the valuation of going concern businesses, securities and intangible assets.

32. The Willamette team conducting the Talbots study was led by Robert F. Reilly, Willamette's managing director and one of its two equity partners. Mr. Reilly holds a BA in economics and an MBA from Columbia University, and is a certified public accountant, a certified management accountant, and is certified as a business appraiser by the Institute of Business Appraisers ("IBA"). He is also accredited in business valuation by the American Institute of Certified Public Accountants ("AICPA") and as a senior appraiser by the American Society of Appraisers ("ASA"). Mr. Reilly has regularly taught classes on valuing intangibles for the AICPA, the ASA, and the IBA, has coauthored two books (Valuing Intangible Assets [the textbook for ASA and IBA certification in valuing intangible assets] and The Handbook of Business Valuation and Intellectual Property Analysis ["The Handbook"]*)*, and has authored or coauthored approximately 300 articles appearing in professional journals, including numerous articles relating to the valuation of intangible assets, royalty rate analysis and trademark analysis. Mr. Reilly was accepted in this matter as an expert in the valuation of intangible assets.

33. In 1988, when Mr. Reilly was a valuation partner at Touche Ross (now known as Deloitte & Touche), his team was asked to perform a purchase price allocation of the assets of

Talbots in connection with Jusco USA's purchase of Talbots from General Mills (***see***, Finding of Fact "7"), so as to arrive at an estimate of the fair market value and remaining useful life of all of the assets of Talbots that were being acquired by Jusco USA.[9] The goal of this study ("the 1988 Study") was to create an opening balance sheet for Talbots as a subsidiary of Jusco USA. The assets to be valued included: (a) working capital assets (i.e., receivables and inventory); (b) intangible assets such as goodwill; and (c) land, buildings, equipment, tangible personal property, and leasehold interests in a number of Talbots' retail stores. Among the intangible assets being valued in the 1988 Study were customer relationships, customer lists, training materials, systems and procedures, and a trained and assembled work force. To value these assets, Mr. Reilly and members of his team used generally accepted valuation methods, including the cost approach method, the income approach method and the market approach method, to value each "bundle" of assets to be assigned a value on the Talbots balance sheet. Mr. Reilly and his team interviewed Talbots management at its corporate offices in Hingham, Massachusetts in connection with the 1988 Study.

34. The results of the 1988 Study were reflected in the 1988 financial statements of Talbots and were carried forward in subsequent financial statements by Talbots, with appropriate modifications (e.g., depreciation and amortization). No adjustments were made, going forward, to reflect any appreciation to tangible or intangible assets identified in 1988, or to recognize additional intangible assets created thereafter.

35. In 1993, Jusco and Talbots again hired Mr. Reilly, now employed with Willamette, to perform an appraisal of the Talbots trademarks so as to establish a purchase price for such

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[9] The Jusco USA purchase of Talbots' stock was, pursuant to IRC § 338(h)(10), treated as a purchase of Talbots' assets.

trademarks that were to be sold to Jusco BV. Mr. Reilly was assisted in this engagement by Manoj Dandekar and Pamela Garland, both of whom had previously worked with Mr. Reilly on the 1988 Study. To perform this appraisal, Mr. Reilly first analyzed the 1988 License Agreement between Jusco BV and Talbots. In turn, Mr. Reilly analyzed the history of the Talbots trademarks through 1993. He then assessed how the Talbots trademarks were likely to be used in the future, based on interviews with Talbots management and other information provided to him by Talbots. Mr. Reilly and his assistants reinterviewed the Talbots personnel that had previously been interviewed in connection with the 1988 Study. In this regard, Mr. Reilly, Mr. Dandekar and Ms. Garland spoke with approximately a dozen Talbots managers working in various capacities for Talbots, including such business functions as marketing research, store selection, store construction, operations, human resources, finance, corporate accounting, and fixed asset accounting, to evaluate the history of the use of the Talbots trademarks and determine the likely future uses to which the Talbots trademarks would be put. Mr. Reilly and his team reviewed historical and projected financial statements, consumer tracking studies, security analyst's reports, and financial and legal documents relating specifically to the Talbots trademarks.

36. The result of this work was the 1993 Study, which concluded that the Talbots trademarks were worth approximately $104,000,000.00. The 1993 Study was presented to Talbots and to Jusco Ltd. on September 15, 1993.

37. In 1996, in response to a number of different states' inquiries (including New York's) concerning Talbots royalty payment deduction, Talbots once again engaged Mr. Reilly and Willamette to conduct a new study and prepare a royalty rate analysis of the value of the

Talbots trademarks as of 1996 ("the 1996 Study").[10] The purpose of the 1996 Study was to estimate a fair arm's length royalty rate for Talbots' license of the Talbots trademarks from Classics for FY 1996 and forward, to be incorporated in an amendment to the 1993 License. Talbots requested that Mr. Reilly perform a study for use nationwide, as opposed to a study tied to the specific tax laws of any one or more states. As described in detail hereafter, Willamette issued its report from the 1996 Study on August 27, 1997, concluding therein the royalty rate for the use of the Talbots trademarks should be 6% of net sales.

38. Mr. Reilly prepared the 1996 Study in accordance with generally accepted valuation standards, attempting to emulate what would happen if unrelated companies with the same characteristics as Talbots and Classics had come together to negotiate a royalty rate for the license of the Talbots trademarks. As with the 1988 Study and the 1993 Study, Mr. Reilly was assisted in the preparation of the 1996 Study by Mr. Dandekar and Ms. Garland.

39. To prepare the 1996 Study, Mr. Reilly relied on his work from the 1988 Study, his work and work papers from the 1993 Study, and additional work performed and work papers generated specifically for the 1996 Study. Mr. Reilly and his assistants relied extensively on their own knowledge of Talbots as developed in 1988 and 1993, the relationships they had developed with Talbots personnel, and the fact that they had already had the opportunity to interview Talbots personnel twice before beginning work on the 1996 Study. Pursuant to Willamette policy, and comporting with the Uniform Standards of Professional Appraisal

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[10] The parties differ as to nomenclature in that petitioner refers to this Study as "the 1996 Study," whereas the Division refers to it as "the 1997 Study." This distinction is apparently due to the fact that a draft report on the Study was given to Talbots by Willamette in September 1996, but the final report was not given until August 1997. Since the Study was commissioned and conducted in 1996, and an initial finding and draft report was conveyed to Talbots by Willamette in 1996, and since the final report is dated "as of June 30, 1996," the Study will be referred to herein as the 1996 Study, notwithstanding Talbots' acknowledgment that the final written report was not physically delivered to Talbots until August 27,1997 (***see,*** Finding of Fact "92").

Practices ("USPAP") regarding the retention of records, Mr. Reilly and his staff retain their work papers for five years before destroying them. Mr. Reilly explained that all of his work papers and notes regarding his functional analyses of petitioner from the 1988 Study and the 1993 Study had, by the time of the subject audit, been destroyed and thus were not available to be provided to the Division.

40. Mr. Reilly and his team performed a functional analysis of Talbots covering the following functions of the business:

(a) strategic planning,
(b) product development,
(c) purchasing,
(d) manufacturing,
(e) distribution,
(f) merchandise (products and location),
(g) store operations (negotiations, design and construction),
(h) marketing (marketing research),
(i) catalog development and advertising,
(j) telemarketing and direct marketing,
(k) human resources (training),
(l) management information systems,
(m) finance (cost of capital),
(n) accounting (tangible and intangible assets), and
(o) legal and regulatory compliance.

41. In interviews with Talbots' marketing, marketing research, and merchandising personnel, Mr. Reilly and his assistants used a standard form questionnaire to frame the discussion for purposes of the functional analysis they performed. The persons interviewed were asked questions relating to two general areas of inquiry, as follows:

> a) how does your department and its job responsibilities and functions fit into the overall operation of Talbots, and
>
> b) what assets do you create or use in performing your job responsibilities and functions.

42. Mr. Reilly used the results of these interviews to identify the functions performed, assets employed, and risks assumed by Talbots in carrying out its business endeavors, so as to gain an overall picture of Talbots' business and the range of its tangible and intangible assets, as well as how Talbots uses those assets. The results also provided a basis for Mr. Reilly to search for comparable companies against which to measure Talbots' performance. He did not, as part of his analyses, interview anyone from Classics.

43. As noted earlier, Talbots is a vertically integrated leading specialty retailer and cataloger selling ladies apparel, accessories and shoes, kids' and babies' apparel, casual wear, dressy wear, outerwear, swimsuits, sportswear, professional women's wear, evening wear, and career wear. Talbots operates in a highly competitive business sector, and changes its product designs about eight times every year. Initially, Talbots sold only other parties' products, but in the mid-1980s Talbots began designing, developing and marketing its own products. In 1988, approximately 25% to 27% of the merchandise sold by Talbots was designed by Talbots and carried Talbots' label on it. By 1996, that percentage had increased to approximately 97%.

44. Talbots' product development office is located in New York City. Talbots works very "tightly with vendors" to develop its products, and Talbots' product developers travel to Europe, London and Asia, read trend magazines, talk to people in the fashion business, and solicit input from Talbots store managers to determine what styles of clothing to produce. Talbots' product development office looks forward about 18 months to determine what styles, colors, and fabrics should be used in the designs of Talbots' clothing. Talbots' product development office then works with Talbots' merchandising office, located in Hingham, Massachusetts to develop the actual styles. Talbots designs all of the patterns, textures, surfaces, features, styling, accessories, and finishing for the products to be produced and sold by Talbots.

The ultimate decisions as to what products will be produced are made by Talbots' merchandising department. Talbots' product designs are unique and Talbots redesigns its products on an ongoing basis to keep the fashions of its products current. Talbots is well known for the style of its clothing, and the 1996 Study concluded that "[Talbots'] technical designers and product developers provide specifications for most of the merchandise manufactured. This has enabled [Talbots] to offer merchandise that differentiates itself from its competitors."

45. The designs and sizes of Talbots products are particular to Talbots' specifications. Talbots does not share any of the specifications of its products with any other parties, and Talbots does not sell any of the products it has produced to any other retailers for sale by such retailers. Talbots, which has no manufacturing facilities, uses approximately 300 different manufacturing vendors to manufacture its products, and all of the manufacturing vendors enter into agreements that require them to keep all of the specifics about Talbots' products confidential. Talbots' sourcing office determines which manufacturing vendors to use for product production, based upon prior performance and by visiting the vendors. Talbots considers its manufacturing vendor relationships extremely important, and Talbots audits all of the manufacturers of its products. Talbots performs extensive quality control on all of the goods it has manufactured.

46. Talbots benefits from economies of scale. In 1996, Talbots had approximately 400 retail stores and was opening about 40 stores per year. Talbots' real estate committee determines where to open stores, and Talbots determines the entire layout of its stores. Every three to four years, Talbots makes major changes to the design of its stores. Talbots' store managers and employees receive a significant amount of training from Talbots, and Talbots has extensive store operating manuals, which are regularly updated. Talbots audits each of its retail stores every year.

47. Talbots operates various concept stores, including Talbots Kids, Talbots Babies, Talbots Petite, and Talbots Accessories and Shoes. Such stores differ from the standard Talbots stores in size and look, products offered, and sometimes in location. Talbots develops the ideas for the concept stores.

48. Talbots sells its products through its stores and by its catalogs. Talbots advertises its products in its stores, by newspaper ads, by magazine ads, and through its catalogs. Talbots sells similar products in its catalogs and in its stores, but the catalogs offer wider selections of products (e.g., more colors, more sizes) than do the stores. There may be items that are offered through one venue and not the other.

49. Talbots typically produces and mails 20 to 27 different catalogs per year. Each of Talbots' catalogs is custom designed and Talbots pays for all of the production, printing, and mailing of the catalogs. Talbots maintains and owns several customer lists with extensive data regarding the buying habits of each of its customers. Talbots utilizes its customer lists to determine to which customers it will send its catalogs. Talbots shares its customer lists with a very limited number of third parties and charges such companies for the use of its lists. Talbots does not share all of its customer information with any third party, but rather only very select information is shared.

50. Talbots has a trained and assembled workforce.

51. Talbots is responsible for developing its long range strategic plans, a matter termed "essential" for the company's long term success by providing focus and goals to achieve.

52. In the management services agreement between Talbots and Talbots Japan, and as confirmed in testimony by Talbots' Chief Financial Officer Edward L. Larsen, Talbots is summarily (self) described in the following terms:

> [Talbots] has developed a unique system for the identification, fixturization, layout, merchandising, operation, franchising, sales, promotion, and operating procedures of a specialty retail store and catalog services providing a distinctive collection of updated classic women's apparel, shoes, and accessories and incidental services with an emphasis on timeless classic styles and has established a high reputation with the public as to style, quality and services.

53. Talbots' forms 10-K, filed with the Securities and Exchange Commission ("SEC"), also reflect this self-view by highlighting certain areas in which Talbots believes it differentiates itself, to its advantage, from its competitors. This view, also acknowledged in the Willamette Report and in Mr. Reilly's testimony, may be generally summarized as follows:

> (a) Talbots' focused merchandising strategy, personalized customer service and continual flow of distinctive and high quality, reasonably priced, classic private label merchandise is attractive to its customers, a majority of whom are college-educated and employed primarily in professional and managerial occupations;
>
> (b) Talbots' catalog operations provide a competitive advantage, and the synergy between Talbots' stores and catalogs, including the ability to offer merchandise in extended sizes and colors, provides important customer convenience as well as a competitive advantage in identifying new store sites and testing new business concepts;
>
> (c) Talbots' merchandise is manufactured to the specifications of its technical designers and product developers, enabling Talbots to offer consistently high quality merchandise which, combined with its focused merchandise selection, commitment to personalized customer service, store site selection, and convenience distinguish Talbots from department stores and specialty retailers, are key factors in Talbots' success and in its ability to outperform the average of companies competing in the same niche market.

54. Talbots' tax department handles all aspects of Classics' tax filings at no charge to Classics.

55. Upon termination of any of the license agreements between Talbots and Classics, Talbots would not have any direct ownership rights or interests in the Talbots trademarks.

56. Based on the results of the interviews, the Talbots records reviewed, his familiarity with the company based on the 1988 Study and the 1993 Study, and his other research, Mr. Reilly determined what intangible assets Talbots had, including which intangible assets were unique to Talbots. Mr. Reilly explained that a unique intangible asset, for purposes of the valuation of intangibles, is an intangible asset that cannot be readily purchased in the marketplace or found in the possession of a competitor. Like the Talbots name, to which Talbots held an exclusive license in all geographic areas except for the Asian territories, a unique intangible is one that can be used by one firm only.

57. Mr. Reilly also compared customer tracking surveys provided to him by Talbots for the years 1992 through 1996. This comparison led him to conclude that Talbots' customer base had grown more desirable over time, in that more Talbots customers in 1995 had higher incomes, were college educated, and were employed, than in previous years. He further concluded from these surveys that Talbots' customers had grown increasingly familiar with the Talbots brand over time, such that Talbots' customers in 1995 were more likely to respond favorably to the Talbots brand than in previous years. Mr. Reilly attributed these positive changes primarily to the Talbots trademarks, based upon the increase in the strength and frequency of favorable responses to the Talbots name as reflected in the surveys, and based upon interviews with Talbots management. This information confirmed to him that while Talbots' products were "made in a classic design and were of very high quality," such products were not unique to Talbots but that like-designed quality classic women's clothing and accessories were available from other merchants. He did acknowledge that certain consistent practices, including focused product design, development, and manufacture, a commitment to product quality and value, customer service and convenience (including the synergies of the store and catalog operations),

and management efficiency (the shared management view that Talbots runs a "tighter ship"), differentiate Talbots from and give Talbots an edge over its competitors.

58. Similarly, Mr. Reilly concluded, based upon interviews with Talbots management and upon a visit to Talbots' Florida distribution center, that the positive changes reflected in the customer surveys were not attributable to Talbots' inventory system which, while highly efficient, was not unique to Talbots as compared with its competitors. In the same vein, based on interviews with Talbots management and upon several visits to different Talbots stores, Mr. Reilly did not attribute the positive changes in customer base desirability and familiarity with the Talbots brand to Talbots' store locations, which were not unique to Talbots as compared with its competitors. On the same bases, Mr. Reilly also concluded that the positive changes were not attributable to Talbots' trained work force which, while highly skilled, was also not unique to Talbots or uniquely skilled as compared to the work forces of Talbots' competitors.

59. Mr. Reilly also determined that software and product design should not be considered intangible assets of Talbots because neither satisfied the accounting definition of an asset. More specifically, Talbots licensed, as opposed to owned, its software, and its product designs, while unique, did not have a useful life longer than one year.

60. Mr. Reilly also reviewed Talbots' "Vision 2000 Plan," a strategic plan for the company that was issued at roughly the same time Mr. Reilly was performing the analyses for the 1996 Study. The Vision 2000 Plan included financial and operational projections for Talbots up through the year 2000. The Vision 2000 Plan identified two goals for Talbots' business that Mr. Reilly determined were relevant to his analyses. Specifically, Talbots planned to expand the number and type of its retail stores so as to create more stores of different kinds, such as Talbots Misses, Talbots Intimate Apparel and Talbots Shoes. In addition, Talbots planned to increase the percentage of private label products it sold in its stores to virtually one hundred percent.

These two goals were significant because they reflected a commitment by Talbots to increase its exploitation of the Talbots trademarks so as to maximize the value that the company could derive from its exclusive right to the use of the Talbots name on its products and in its stores. The effect of these goals and projections on Mr. Reilly's analysis was to lead him to conclude that the estimated arm's length royalty rate for the Classics to Talbots license should be toward the higher end of any applicable range of rates that he determined to be appropriate for the license between Classics and Talbots.

61. Mr. Reilly also reviewed the history of Talbots through its initial public offering and thereafter up until mid-1996, noting the 50-year history of the Talbots name and the history of the company's uses of the Talbots trademarks. Mr. Reilly reviewed the financial statements of Talbots, including its balance sheets and income statements. He also performed extensive research on the apparel industry to understand industry trends, revenue trends, profitability trends, and returns trends, so as to identify a set of guideline publicly traded companies, i.e., Talbots competitors, against which Mr. Reilly could measure the performance of Talbots and the Talbots trademarks. This information was already well known to Talbots management and was only briefly outlined in the final version of the 1996 Study.

62. The interviews and the data gathered and reviewed, as described herein, are the same kinds of research activities that would be engaged in during the course of a study conducted pursuant to Internal Revenue Code ("IRC") § 482 and according to the procedures and methods set forth in the regulations promulgated with respect thereto (the "Section 482 Regulations").

63. Having conducted the interviews, reviewed the documents provided by Talbots and Classics, and gathered the market data, Mr. Reilly used the three approaches generally accepted for the valuation of intangibles to perform the analyses summarized in the 1996 Study, to wit, the "cost-based approach," the "market-based approach," and the "income-based approach." Mr.

Reilly's method was to apply each of these three approaches, in sequence, to the greatest extent possible relying on the data actually available to him. The use and synthesis of these approaches to reach a final conclusion regarding an arm's length royalty rate for the license of intangible assets conform to the Uniform Standards of Professional Appraisal Practices ("USPAP") and with established procedures and methods used by valuation professionals.

64. Since 1990, the Appraisal Foundation, an independent agency funded by the United States government, has issued valuation standards, USPAP, on a yearly basis for use nationwide by professional appraisers. The 1996 Study was specifically prepared in accordance with USPAP standards. It is standard practice for valuation experts to arrive at an arm's length royalty rate for a license of intangible assets, such as the Talbots trademarks, under USPAP procedures and standards. One set of USPAP standards relates to the valuation of intangible assets, and Mr. Reilly followed those standards in performing the analysis that led to the 1996 Study.

65. USPAP standards, as distinguished from the Section 482 Regulations, require the appraiser to use as many approaches and methods as possible to arrive at an arm's length royalty rate. By contrast, the Section 482 Regulations limit the appraiser to using the single best method. In addition, businesses negotiating contracts with unrelated parties expect an appraiser will use multiple valuation methods and approaches to provide the most accurate possible pinpoint estimate of a royalty rate for a license of intangible assets and will provide those clients with as much relevant market data as can be assembled to support that rate. Appraisers are required by federal law to observe USPAP standards in any appraisal that relates to a transaction in which a federally regulated financial institution provides the financing. Other than small state-chartered banks, virtually every financial institution financing such transactions is federally regulated. USPAP standards are required to be applied in Bankruptcy Court valuation matters,

and the AICPA, ASA, and IBA all require certified analysts to perform their evaluations pursuant to USPAP standards, unless an exception is claimed. One specific exception to the requirement that certified appraisers follow the USPAP standards is for studies performed pursuant to the Section 482 Regulations, which must be clearly labeled as in compliance with the Section 482 Regulations and not USPAP standards.

66. The 1996 Study was prepared in accordance with generally accepted valuation principles, and was also prepared in a manner consistent with the principles underlying IRC section 482. The 1996 Study was admittedly not, however, a Section 482 Study and was not prepared in strict accordance with the Section 482 Regulations and the procedures set forth therein. Mr. Reilly is fully familiar with IRC § 482 and the Section 482 Regulations, and has routinely performed royalty rate analyses pursuant to such Regulations for both taxpayers and the IRS. He explained that he did not conduct the 1996 Study or prepare his report pursuant to the Section 482 Regulations because he was not hired by petitioner to prepare such a report pertaining to international transfer taxation, because the Section 482 Regulations conflict with the USPAP standards in certain key respects, and because he believed that the USPAP standards would produce a more reliable result. In this regard, he explained that the purpose of the 1996 Study was to set a royalty rate based on the best assessment of the *prospective* value of the Talbots trademarks as of 1996 and going forward, whereas IRC § 482 and the Section 482 Regulations are, in contrast, designed as a *retrospective* (i.e., after the fact) method to test whether a chosen rate falls within a reasonable range of arm's-length rates. Mr. Reilly stated that the differences between the methods prescribed by the USPAP standards versus those set forth in the Section 482 Regulations reflect the different goals of the two types of analysis, with the former aimed at establishing a royalty rate for the parties to use to complete a present and

forward looking transaction while the latter is aimed at (later) testing the reasonableness of such a chosen rate.

67. Mr. Reilly noted that an analysis conducted pursuant to the Section 482 Regulations applies a single best analytical method to arrive at a royalty rate range that establishes the upper and lower limits on what a reasonable royalty rate would have been for the already completed transaction under audit. If the existing rate pursuant to such agreement and transaction falls within the range of rates established by the Section 482 Regulation analysis and result, the IRS makes no adjustment to the rate for Federal tax purposes. In contrast, if the rate falls outside that range, the IRS adjusts the taxpayer's income using the middle of the royalty rate range established by the analysis performed pursuant to the Section 482 Regulations. According to Mr. Reilly, because it is not designed to determine and arrive at a specific royalty rate, but rather is designed to arrive at a general royalty rate range so as to test the appropriateness of a specific royalty rate, a study performed pursuant to the Section 482 Regulations cannot, strictly speaking, be used to set a specific pinpoint estimate for a royalty rate that could be used by the parties to an actual license agreement.

68. Another chief difference between the 1996 Study and a report prepared under the Section 482 Regulations is that the latter type of report, because it is prepared for the IRS and not the taxpayer, requires more extensive narrative reporting of the industry analysis and functional analysis performed by the analyst. A report prepared for a client typically does not involve the same level of narrative detail because the client already knows the industry in which it competes (***see***, Finding of Fact "61"). Thus, the level of narrative detailing of documentation in the research performed by Mr. Reilly in the 1996 Study was less than he would have included in a study performed pursuant to the Section 482 Regulations. However, Mr. Reilly stated that the underlying analyses he performed, based on his studies of Talbots on three separate

occasions, would have permitted him to prepare a report satisfying the documentation requirement of the Section 482 Regulations.

69. Neither party disputes that the results of a study performed pursuant to the USPAP standards could coincide with the results of a study performed pursuant to the Section 482 Regulations, such that the point estimate royalty rate resulting from a USPAP standards study would fall within the royalty rate range estimate resulting from a Section 482 Regulations study.

The Methods Used in the Willamette Study

70. As previously stated, in performing his work, Mr. Reilly considered three categories of valuation method. He first attempted to use a cost-based approach, which involved an assessment of the costs which would be incurred in recreating the Talbots trademarks from scratch, including an evaluation of the costs of registering the marks and the costs of advertising and promoting the marks to create the level of brand awareness, consumer recognition and customer loyalty that the Talbots trademarks in fact enjoy. If such costs can be accurately measured, then the replacement cost of the marks can be multiplied by a fair rate of return to determine a royalty amount, which can then be divided by the annual revenues of the licensee to arrive at the proper royalty payment. Mr. Reilly concluded that the cost-based approach, which works best in the valuation of a single trademark of recent vintage, was not an effective or practical method to value the Talbots trademarks because the Talbots trademarks encompassed a wide family of marks that had existed for several decades.

71. Mr. Reilly next attempted to use a market-based approach, which involved a search for comparable uncontrolled transactions ("CUTS"). Reliable CUTS may involve either the actual licensor (Classics) or licensee (Talbots). Alternatively, a reliable CUT may be found in a license agreement between a specialty retailer that competes with or resembles Talbots and a trademark-holding company that resembles Classics. However, typically, it is rare to find

satisfactory CUTS in the valuation of intangible assets, and it was more so the case in 1996 before widespread access to the Internet and Internet search engines became available as a means of finding information. Mr. Reilly's search for CUTS did not reveal any satisfactory CUTS. He did, however, discover some market-related information that he determined could have corroborative value for his analysis (***see,*** Findings of Fact "90" and "91").

72. Mr. Reilly next attempted to employ another market-based approach, the comparable profit margin method ("CPM"), which involves a comparison of the profit margins of direct competitors of Talbots. After adjusting the comparison for the value of intangibles that are not the subject intangibles, i.e., not the value of the Talbots trademarks, and adjusting for other intangibles that the comparable companies do not have in common, the analyst under this approach determines the difference between the profit margins of the firms being compared. That difference should reflect the value of the subject intangible, i.e., the Talbots trademarks. After performing this analysis, Mr. Reilly concluded that the adjustments required to make the other companies identified in the study comparable to Talbots decreased the reliability of this method such that it should not be given primary weight, though its result could still be useful as corroboration.

73. Mr. Reilly employed two variants of the income-based approach, to wit, the residual profit split method ("RPSM" or [per USPAP terminology] "excess earnings method-company specific"), and the profit split method ("PSM" or [per USPAP terminology] "excess earnings method-guideline publicly traded specific"). Of the income based methods he employed, Mr. Reilly gave the RPSM the greatest weight, and expressed his belief that if he had conducted a study in compliance with IRC § 482 and the Section 482 Regulations, the RPSM would have been the "best method" in the subject circumstances.

74. The RPSM employed by Mr. Reilly involved first splitting the (projected) operating income of Talbots between the tangible assets and intangible assets reflected on Talbots' financial statements which generated such income (i.e., operating income being considered the return generated from all of the assets employed by the business). The final split among the intangible assets serves to separate out the value to be attributed to the subject intangible, to wit, the Talbots trademarks licensed from Classics. Mr. Reilly explained that projected earnings figures, rather than (audited) historical earnings figures, are utilized because the parties to a license agreement are interested in capturing the value of the licensed intangibles going forward to the end of the proposed license term, and that as forward-looking projections, such amounts could not, by definition, be audited amounts.

75. Mr. Reilly began with Talbots' projected earnings before interest, taxes, depreciation and amortization ("EBITDA"), the generally accepted starting point among valuation analysts for a residual profit split analysis. This amount, $201,428,000.00, consisted of Talbots projected earnings before interest and taxes ("EBIT") of $153,793,000.00, plus depreciation and amortization of $47,635,000.00.

76. Mr. Reilly next used Talbots' balance sheet to determine:

> (a) the $162.8 million amount of Talbots' net plant, property, and equipment (fixed assets), meaning all real estate and personal property owned or leased by Talbots and all store fixtures owned by Talbots that were already on the Talbots balance sheet;
>
> (b) the $47 million amount of Talbots' identified intangible assets consisting of net goodwill ($43.5 million) and other intangible assets ($3.5 million), including therein (in Mr. Reilly's view) the value of Talbots' assembled and trained workforce, its customer relationships, and its owned computer software;
>
> (c) the $154 million amount of Talbots' net working capital, consisting of inventory ($154.6 million) and accounts receivable ($77.9 million) less notes payable ($49 million) and accounts payable ($30.2 million)

Mr. Reilly expressed his confidence that these figures represented “real” values and not merely “bookkeeping” values because they were figures that had been initially determined as the result of the 1988 Study conducted to determine and allocate the fair market value and remaining useful life of all of Talbots’ assets in connection with an actual arm’s length transaction between unrelated parties, to wit, the 1988 sale of Talbots by General Mills to Jusco USA. Such figures, as initially established, were then rolled forward on Talbots’ balance sheets for ensuing years, with appropriate annual adjustments.

77. Mr. Reilly then applied a required before tax rate of return to the value of each of these segregated categories or classes of assets, a step designed to capture the market cost of capital based on the nature of the particular class of assets and the relative risk of such category or class of assets. In this case, the rates of return he applied to the asset values, per category or class, were 20% on fixed assets, 25% on intangible assets, and 6.5% on working capital assets, respectively.

78. This series of segregations and calculations resulted in approximately $54 million of Talbots’ approximately $201 million of operating income being derived from and allocable to its identified and recorded tangible and intangible assets (that is, the income assigned as “returnable to capital structure”), thus leaving approximately $147 million of excess operating income (cash flow) allocable to Talbots’ unidentified intangible assets, appreciation over time, and the Talbots trademarks.

79. Mr. Reilly stated his belief that Talbots possessed additional intangible assets other than the Talbots trademarks, including systems and procedures and training manuals as well as unrecorded appreciation in those assets, the value of which had not been captured in any of the categories discussed above. He expressed his view that the value of such other assets was not trivial, but also that such assets were not unique. In view of this belief, and upon his knowledge

and judgment based on the information gleaned from conducting the 1988 Study and the 1993 Study, and the functional analysis performed in connection with the 1996 Study, Mr. Reilly attributed 50% of the remaining $147 million in excess income to the Talbots trademarks and the other 50% to the remaining (additional) unidentified intangible assets. His selection of the 50% figure for intangibles other than trademarks was calculated to impart a downward bias on the ultimate royalty rate for the trademarks. In this regard, Mr. Reilly stated his opinion that his 50% allocation to trademarks was a conservative allocation which might "somewhat undervalue" the portion of the excess earnings attributable to trademarks, again stating his conclusion that the other intangibles, while not "trivial," were not unique and thus, at least individually, did not have a "significant value" vis-a-vis generating Talbots' residual profit (or excess earnings). It follows that if he had not included in his analysis such a downward bias, the ultimate royalty rate produced by the RPSM would have been higher than the indicated actual rate identified by Mr. Reilly. Using the RPSM, Mr. Reilly arrived at an indicated royalty rate for the Talbots trademarks of 5.4%.

80. The second primary method on which Mr. Reilly relied was the income based PSM. The central difference between the RPSM and the PSM is that a different measure of income is split into a different bundle of assets. The PSM, like the RPSM, begins with the same measure of projected sales, $1,361,000,000.00, which yields the same projected net operating income, $153,793,000.00, representing EBIT. Mr. Reilly explained that in the PSM, depreciation and amortization are assumed to represent the fair return on identified tangible and intangible assets. Accordingly, Mr. Reilly did not add back depreciation and amortization, as reflected on Talbots' financial statements, to arrive at EBITDA, or attempt to allocate among or with regard to tangible and intangible assets on such statements, but rather based the allocation of projected net operating income solely on EBIT.

81. Mr. Reilly used the same 50% profit split, as above, to divide the EBIT figure, which represents all income remaining to be allocated to intangible assets, between routine (i.e., nonunique) intangible assets and unique (i.e., nonroutine) intangible assets, with the latter being the Talbots trademarks. As before, Mr. Reilly selected the 50% profit split based on the data he and his staff obtained through the functional analysis of Talbots in 1996, the information about Talbots that they had garnered performing the 1988 Study and the 1993 Study, and his judgment that he should incorporate a downward bias to the ultimate result. The PSM produced an indicated royalty rate of 5.7%.

82. The third primary method employed by Mr. Reilly was the approach known as the excess earnings method ("comparable profit margin" or "CPM" method).[11] In an ideal situation, the CPM would compare Talbots' total EBITDA to the total EBITDA of comparable companies. However, because Mr. Reilly could not find truly comparable companies, he compared Talbots to industry benchmark figures. Further, because he could not find accurate EBITDA figures for the industry benchmarks on which he relied, Mr. Reilly compared the EBIT of Talbots to the average EBIT of the industry benchmarks. Specifically, Mr. Reilly compared the EBIT percentage, or margin, of Talbots to the average EBIT percentage, or margin, of the industry benchmarks, with the latter based on three Standard Industrial Classification ("SIC") Codes ("5621–Women's Ready-to-Wear Garments," "5611–Men's and Boy's Clothing," and "5651–Family Clothing") and the information relative thereto taken from the Robert Morris

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[11] There is some apparent confusion over whether the CPM was a "primary" method entitled to be relied upon as such, or was a "confirmatory" method. Unlike the three confirmatory methods (***see,*** Finding of Fact "85"), the CPM did, like the two acknowledged primary methods (the RPSM and the PSM), arrive at a royalty rate point estimate. Moreover, petitioner's proposed finding of fact "193" refers to the CPM as "the . . . third primary method," as does the Division's proposed finding of fact "162." However, at proposed finding of fact "168", petitioner admits that because of the number of comparability adjustments necessary, Mr. Reilly concluded that the CPM should not be given primary weight, but was still entitled to be used as "corroboration." Hence, though properly termed a "primary method," the CPM is not a method the result of which is entitled to be accorded "primary weight" (***see,*** Finding of Fact "72").

Associates "Annual Statement Studies," the "Almanac of Business and Financial Ratios," and the "IRS Composite Financial Ratios."

83. Mr. Reilly used an industry average EBIT margin, 3.6 %, as opposed to the 1.3% EBIT margin of the benchmark most closely comparable to Talbots, the Robert Morris Associates 1996 annual statement study of women's ready to wear retailers. Mr. Reilly's use of the (higher) industry average EBIT margin to subtract from the Talbots actual EBIT margin had the effect of narrowing the difference by which Talbots' performance exceeded the industry margin, thereby placing a further downward bias on the indicated royalty rate for the Talbots trademarks. That is, had Mr. Reilly used the 1.3% figure drawn from the Robert Morris study, the indicated royalty rate would have been higher because the excess EBIT above the industry benchmark would have been 2.3% points higher.[12]

84. Applying the results of his research, Mr. Reilly took the foregoing EBIT margin difference, i.e., Talbots' excess EBIT margin over the industry average, and applied it to the projected net sales figure for Talbots, deriving as a result $148,606,000.00 as Talbots' excess income above the industry average excess income. Mr. Reilly attributed this entire figure ($148,606,000.00) to intangible assets based on the assumption that, for purposes of this method, the fixed assets of Talbots (***see,*** Finding of Fact "76 [a]") and the fixed assets of the industry benchmarks were equivalent, whereby Talbots did not have any economic advantage over its competitors based on the types of fixed assets it possessed as compared with its competitors. He applied the same 50% profit split that he had applied in the RPSM and PSM analyses to the $148,606,000.00 excess income figure, to arrive at $74,303,000.00 of excess income attributable

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[12] Petitioner's Proposed Finding of Fact "199" states that the excess EBIT above the industry benchmark would have been 2.5% higher, an apparent typographical error since the difference between the industry average EBIT margin (3.6%) and the Robert Morris study EBIT margin (1.3%) is 2.3%.

to the Talbots trademarks. His choice of a 50% split was made upon the same basis as described earlier, to wit, the functional analysis performed in the 1996 Study, the information learned from the 1988 Study and 1993 Study, and his desire to impart a downward bias to the value. The result of applying the excess earnings method was an indicated royalty rate for the Talbots trademarks of 5.5%.

85. In addition to the foregoing primary methods of analysis, Mr. Reilly employed three confirmatory methods of analysis, to wit, the "guideline publicly traded company method," the "advertising expense analysis," and the "sales per square foot analysis." These analyses did not result in the determination of a specific royalty rate, but provided Mr. Reilly with some guidance as to whether he should choose the higher or lower end of the point royalty rates determined pursuant to his other (primary) methods (***see***, Finding of Fact "60").

86. In applying the guideline publicly traded company method, Mr. Reilly compared the performance of Talbots with the performance of a set (or class) of guideline publicly traded companies to which Talbots, and investment firms monitoring Talbots, regularly compare Talbots' performance. Mr. Reilly did not view or treat these guideline publicly traded companies as strict comparables, but rather as providing relevant market evidence to corroborate the indicated royalty rates determined pursuant to his primary methods.

87. The use of a set of guideline companies, including companies such as Liz Claiborne and Jones New York that have valuable trademarks, imparted a downward bias to the royalty rate indicated by this method because a strict comparative analysis would not have included any companies with valuable trademarks among the class of comparables. Mr. Reilly's analysis indicated that for a number of comparative metrics, including growth rate in EBIT, growth rate in EBITDA, debt-free net income, debt-free cash flow, and compound annual growth rate of revenue, Talbots was significantly outperforming its recognized peers. Mr. Reilly used the

guideline publicly traded companies method as confirmation that Talbots' growth and profitability significantly exceeded those of its peers. Putting this information together with the result of the functional analysis performed by Mr. Reilly led him to conclude that a significant contributing factor to Talbots' rapid growth and increase in profitability was the Talbots trademarks. Mr. Reilly's analysis under this method did not result in the determination of a specific royalty rate (or range of rates).

88. To apply the advertising expense analysis, Mr. Reilly compared Talbots' advertising expenses as a percent of revenues, to the advertising expenses, as a percent of revenues, of the guideline publicly traded companies which are operationally similar to Talbots, and also to the advertising expenses, as a percent of revenues, of Yes Clothing Company, which is similar to Talbots in that it is a licensee of the trademarks and names that it uses. This analysis revealed that Talbots incurred, as advertising expenses, between 1.0% and 1.5% less of its revenue than did the peer companies. From this, Mr. Reilly concluded that the Talbots trademarks were more valuable than those of its peers, because it cost Talbots less to generate sales under those trademarks than it cost competitors to generate sales under their trademarks or names. The purpose of the advertising expense analysis was not to establish an indicated royalty rate, but rather was to provide some indication as to whether the royalty rate ultimately chosen should be at the higher or lower end of the range of rates indicated by the other methods. As applied to Talbots, the advertising expense analysis indicated that the royalty rate to license the Talbots trademarks should be pegged at the high end of the spectrum. Again, under this second confirmation method, Mr. Reilly did not arrive at a specific royalty rate (or range of rates).

89. To apply the sales per square foot analysis, Mr. Reilly compared the average sales per square foot of those guideline publicly traded companies that had retail stores, to the average sales per square foot of Talbots' retail stores. Mr. Reilly concluded, on the basis of his

functional analysis, that any difference in sales per square foot between Talbots and its competitors should be attributed primarily to the value of the unique Talbots trademarks as opposed to the features of the Talbots' stores, which he viewed as valuable but not unique. Ultimately, this analysis provided further evidence of the strength of the Talbots trademarks as contrasted with those of Talbots' competitors in the market. Again, no specific royalty rate (or range of rates) was determined.

90. The 1996 Study also included additional market evidence that Mr. Reilly considered relevant to his analysis and relevant to Talbots, but which could not be specifically incorporated into any one of the six methods of analysis described herein. For instance, he obtained information regarding licensing agreements between clothing retailers (as licensees) and licensors for the use of certain marks or names on apparel. These licensees typically do not own any fixed assets, but rather contract with manufacturers to make certain clothes to carry the particular licensed brand name to be sold by the licensee. Mr. Reilly determined that the three such agreements most closely resembling the Talbots to Classics relationship were a license from No Excuse Jeans to New Retail Concepts, Inc., a license from Body Glove International to Yes Clothing, and a license from G. Marciano to Yes Clothing. While Mr. Reilly did not consider that these license agreements could, or should, be treated as CUTS, and were "not really good comparables at all," he concluded that they did provide general information regarding royalty rates in the apparel industry, which typically fell within the 5% to 7% range.

91. As additional market evidence, Mr. Reilly reviewed An Insider's Guide to Royalty Rates (Gregory J. Battersby and Charles W. Grimes), a book presenting data gathered on royalty rates in various industries, including the apparel industry, which is routinely consulted by valuation analysts. He utilized three categories of apparel, to wit, Collegiate (with a royalty rate range of 6% to 8% of net revenues), Corporate (with a royalty rate range of 5% to 7% of net

revenues) and Designer (with a royalty rate range of 3% to 7% of net revenues). This source provided additional market evidence that a royalty rate range of between 5% and 8% was appropriate for the apparel industry.

92. Based on the results of the primary methods used, the upward bias suggested by the confirmatory methods, and the market evidence, as each is described above, Mr. Reilly ultimately concluded in the 1996 Study that a royalty rate of 6% of net sales was an appropriate point estimate for the license agreement between Classics and Talbots. At Talbot's request, Mr. Reilly held off on completing his final report until the boards of directors of Talbots and of Classics had signed off on the amended License which, among other things, adjusted the royalty rate for the license between Classics and Talbots. Upon approval of the boards of directors of Talbots and Classics, the royalty rate under the license was set at 6% of net sales for all quarterly periods beginning with FY 1996. Upon such approval, and execution of that agreement, Talbots asked Mr. Reilly to furnish a completed report at Mr. Reilly's convenience. His completed report, dated as of June 30, 1996, was furnished to Talbots on August 27, 1997. In this regard, Mr. Reilly explained that in his experience such a delay between reporting the indicated royalty rate to a client and actually furnishing a completed report is common, inasmuch as such engagements and related or dependent deals are often time-sensitive as to the rate, but not as to the supporting analysis.

93. Mr. Reilly also presented at the hearing a calculation of the profit split between Talbots and Classics for FY 1996, based on the actual, as opposed to projected, results for that period. Based on the actual EBITDA of Talbots and Classics for such period, the profit split between the two companies was 36% to Classics and 64% to Talbots, which comports with his judgement at the time of performing his analyses that approximately one third of the total

operating income should be assigned to the Talbots trademarks, one third to Talbots' other intangible assets, and one third to Talbots' identified assets.

94. Mr. Reilly also concluded, and noted at hearing, that the Talbots trademarks become more valuable as they are used on more than one product or service, and that they had substantially appreciated in value between 1994 and 1995, and thereafter between 1996 and 2000.

95. The Division subpoenaed all of Willamette's work papers and correspondence relating to the 1996 study, and also demanded by subpoena complete copies of all Willamette reports issued to Jusco, Ltd. and Talbots (or any of their affiliates or subsidiaries), complete copies of all "draft" reports issued to any of such entities, and complete copies of all correspondence between Willamette and Talbots (and any affiliated company) regarding preparation and completion of any report prepared by Willamette. In response, the Division received a copy of a draft Willamette report, dated September 18, 1996. This draft report advanced a royalty rate of 5%, as opposed to the 6% rate appearing in the final report dated August 27, 1997.

The Division's Report

96. The Division introduced the testimony of Dr. Ednaldo Silva. Dr. Silva holds a PhD in economics from the University of California at Berkeley. He is a Fullbright Scholar and professional economist, taught economic development and statistics at Berkeley and at the New School for Social Research, and was employed by the IRS as an industry economist. He later transferred to the Office of the Chief Counsel of the U.S. Department of the Treasury, where he served on the Section 482 Regulations drafting team. Dr. Silva was accepted as an expert in economics, transfer pricing, and in IRC § 482 and the Section 482 Regulations. Dr. Silva furnished a report ("the Silva Report") as a critique of the 1996 Study performed by Willamette.

97. Dr. Silva stated his opinion that the only way to establish that a rate for a royalty payment between related parties is an arm's length rate is to perform a study pursuant to the Section 482 Regulations. Dr. Silva was not, however, engaged to perform, nor did he perform, a study pursuant to the Section 482 Regulations to determine the propriety of the royalty payment rate between Talbots and Classics for the use of the Talbots trademarks, or to calculate an arm's length royalty rate range for the purpose of determining whether the 6% figure identified by Mr. Reilly and agreed to between Classics and Talbots in the 1996 amendment to their license agreement fell within that range. Dr. Silva did not test, nor was he asked to test, the factual accuracy of the royalty rate of 6% identified by Mr. Reilly in the 1996 Study. In view of these facts, Dr. Silva expressed no opinion as to what the actual proper arm's length rate, or range of rates, could or should be for the royalty payment from Talbots to Classics for the use of the Talbots trademarks. Dr. Silva agreed with Mr. Reilly that the 1996 Study was not a study performed pursuant to the Section 482 Regulations, but rather was a study performed pursuant to USPAP standards.

98. Dr. Silva did not interview any Talbots personnel in connection with preparing his report or prior to providing his testimony at hearing. He also admitted that he is not fully familiar with, and thus is not qualified to opine with regard to, the USPAP standards, whether they measure an arm's length rate, or as to the manner of application of the USPAP standards by Mr. Reilly. He further acknowledged that a study performed pursuant to USPAP standards, and the result derived therefrom, could pass muster under the standards set forth in the Section 482 Regulations, such that it is possible the 6% royalty rate arrived at for FY 1996 and forward would fall within the range of rates that would result from a study performed pursuant to the standards set forth in the Section 482 Regulations.

99. Dr. Silva's testimony in this matter was focused mainly on a discussion of the ways in which Mr. Reilly's method deviated from the procedures set forth in the Section 482 Regulations, and his opinion as to the consequences resulting therefrom. Dr. Silva was critical of the 1996 Study for failing to conform to the procedural requirements of the Section 482 Regulations, and of Mr. Reilly's use of unaudited consolidated financial statements, as opposed to separate audited financial statements, to perform his analyses. He admitted, however, that separate audited statements for Talbots and Classics were not available, that it was proper to rely on projections of future performance to establish a royalty rate "going forward," and noted that projections by definition are not audited numbers. Dr. Silva testified that in his view that it was "unlikely" the chosen 6% royalty rate would fall within the range of rates that would result from a study performed pursuant to the standards set forth in the Section 482 Regulations, but he declined to speculate on the degree of that likelihood.

100. Dr. Silva pointed out that Classics had an unusual and extraordinarily high operating profit margin of approximately 85%. In this regard, he explained his belief that there were expenses which were incurred by Talbots but which should have been allocated, in part or in whole, to Classics as the owner and licensor of the Talbots trademarks. He stated that it is important to ask and determine what factors drive and add to the value of the Talbots trademarks and take such factors into consideration when determining a royalty rate. He concluded, in view of the respective functions performed, assets employed and risks assumed, that the Talbots trademarks were "kept alive" and "driven" by Talbots and not by Classics. In this regard, he concluded that two of the most significant functions which drove the value and success of the Talbots trademarks were the design and advertising functions, both of which functions and their associated expenses were performed and paid for by Talbots and not by Classics.

101. Dr. Silva criticized the RPSM and PSM, employed by Mr. Reilly as violating the requirements of the Section 482 Regulations. He agreed with Mr. Reilly, however, that the RPSM or PSM were the best methods to use to calculate the proper arm's length royalty rate for the royalty payments from Talbots to Classics for the use of the Talbots trademarks. Dr. Silva agreed that it would have been very difficult to have found CUTS, because the standards for the application of a CUT are very stringent under the Section 482 Regulations, and that although he did not search for CUTS himself he believed no such CUTS could have been found.

102. Dr. Silva also criticized Mr. Reilly for adding an alpha, or company specific risk premium, factor to the Capital Asset Pricing Model ("CAPM") equation he performed to calculate the after tax cost of equity in the 1996 Study. Dr. Silva also criticized Mr. Reilly for his reliance on certain data from Ibbotson Associates SBBI 1996 Yearbook ("Ibbotson") in his CAPM equation to calculate the after tax cost of equity. Most specifically, Dr. Silva disagreed with Mr. Reilly's reliance on Ibbotson historical data for small company stock, and with his use of data covering the (long) time period spanning 1926 to 1995 because the same reflected a large standard deviation. Dr. Silva explained that if he were to have performed his own calculation of the historical returns used in the 1996 Study, he would have used approximately seven years worth of historical data to do so. He acknowledged, at the same time, that this approach deviates from the strictures of the Section 482 Regulations, which require the analyst to use only three years of historical data, but stated that such deviation (using seven years versus three years of data) would be merited because three years worth of historical data for stocks would not be a reliable measure. Notwithstanding his criticism of the methods Mr. Reilly used to determine historical returns, Dr. Silva did not perform his own calculation of such returns.

103. Dr. Silva criticized Mr. Reilly for including additional market data in his report, including data regarding the guideline publicly traded companies identified by Mr. Reilly, the

list of license agreements relating to the apparel industry, and data from the Insider's Guide to Royalty Rates (***see,*** Findings of Fact "86 through 91"), and stated his opinion that Mr. Reilly should have completely disregarded this market data.

104. The ultimate conclusion of Dr. Silva's review of the 1996 Study was that the 6% royalty rate identified by Mr. Reilly in the 1996 Study and agreed to by Classics and Talbots in the amendment to their license agreement did not represent a number established by or confirmed pursuant to the Section 482 Regulations and, by implication, was therefore inherently suspect if not unreliable. Dr. Silva did not conclude that the 6% rate was not the appropriate arm's length rate, or that such rate would not fall within the range of arm's length rates which would result from the conduct of a study pursuant to the Section 482 Regulations, but did opine that from his experience, the 6% rate "seemed excessively high."

The IRS Audit and the New York State Audits

105. The IRS performed an audit ("the IRS audit") of Talbots' Federal income tax returns for FY 1991 and FY 1992, as part of which the IRS reviewed Talbots' Federal form 1120 ("U.S. Corporation Income Tax Return") for the consolidated group that included Jusco USA, Talbots, and Talbots International. Jusco BV was not part of the consolidated group, the income from which was reported on Talbots' Form 1120, although Talbots and Jusco BV were affiliated companies and Talbots paid royalties to Jusco BV during FY 1991 and FY 1992 in the approximate amounts of $9 million and $10 million for such years, respectively. The operative royalty rate during those fiscal years was 1.8% of net sales (***see***, Finding of Fact "10"). During the course of the IRS audit, the deductions taken by Talbots for its royalty payments to Jusco BV were questioned. The IRS audit was concluded, however, without any adjustment (reduction) being made to Talbots' deductions for such royalty payments either pursuant to IRC § 482 or the Section 482 Regulations, or otherwise (i.e., deduction elimination) as a sham transaction. There

is no claim or evidence that the IRS performed a study pursuant to the Section 482 Regulations as part of its challenge to the royalty payment deductions.

106. After the IRS audit concluded, Talbots filed an amended New York State corporation franchise tax report which included a copy of the IRS audit report. During the course of its audit of Talbots for FY 1994 through FY 1996, the Division's auditors made no request for information from Talbots regarding the IRS audit. However, after completion of the audit, the Division became aware that Talbots claimed the IRS previously reviewed the royalty rate between Talbots and Jusco BV and had made no adjustment for the royalty payment deductions based thereon. The Division's auditor contacted the IRS and attempted to obtain information regarding any IRS review of the royalty rates at issue. He was informed by a representative of the IRS that, to that representative's knowledge, intercompany pricing "was not an issue" in the Federal audit of petitioner for the period 1991 through 1993.

107. The Division has performed three corporation franchise tax audits of Talbots and its affiliated companies since 1988. The first audit covered the fiscal years 1988 through 1990, during which time period Talbots made royalty payments to Jusco BV for the use of the Talbots trademarks. Talbots took deductions for royalty payments on its franchise tax reports for fiscal years 1988 through 1990. It did not file combined New York franchise tax reports including Jusco BV for such fiscal years. The Division did not seek to combine the income of Talbots and Jusco BV, nor did the Division disallow the deductions taken by Talbots for the royalty payments to Jusco BV as the result of its audit for the fiscal years 1988 through 1990.

108. The second audit, which began in 1996 and concluded in 1997, covered FY 1991, FY 1992, and the fiscal year ended January or February 1994 ("FY 1993"). During the time period covered by the second audit, Talbots made royalty payments to Jusco BV for use of the Talbots trademarks until November 1993. Talbots did not file combined New York franchise tax

reports including Jusco BV for the fiscal years 1991 through 1993. On its franchise tax reports for such fiscal years, Talbots took deductions for its royalty payments to Jusco BV.

109. After November 1993, Talbots made royalty payments to Classics at the same operative rate that Talbots had made payments to Jusco BV before the acquisition of the Talbots trademarks by Classics, and took a deduction for such royalty payments to Classics on its New York franchise tax report for FY 1993. Talbots did not file a combined New York franchise tax report including Classics for FY 1993.

110. At the time of the second audit, it was the policy of the Division to pursue combination of affiliated companies that met the requirements for combination under Article 9-A of the Tax Law. Pursuant to that policy, the Division challenged the deduction for royalties paid by Talbots to Jusco BV and Classics during FY 1991 through FY 1993. During the second audit, the Division reviewed the trademark loan agreement between Talbots and Classics, which funded Classics' purchase of a portion of the Talbots trademarks from Jusco BV, and the license agreement between Talbots and Classics. During the second audit, the Division was also apprised that the IRS had audited Talbots for FY 1991 and FY 1992 and had made no adjustments to Talbots' Federal income tax return for the deductions taken by Talbots for royalty payments it made to Jusco BV. The Division's auditor on the second audit reviewed Talbots' Federal tax returns for FY 1991, FY 1992, and FY 1993.

111. The Division's auditor stated her belief that the option to combine Talbots with Jusco BV did not exist (specifically at the time of the second audit) because Jusco BV was an alien corporation. The auditor also stated that even though the Talbots trademarks had been transferred to Classics, (a foreign as opposed to alien corporation) during the audit cycle, the amount of time during which Classics held the trademarks was not very long and the dollar amount at issue would, therefore, not be very significant. The Division did issue a Notice of

Deficiency for a relatively small amount of tax as a result of the second audit based on an audit finding that was wholly unrelated to the royalty payments made by Talbots to Jusco BV and to Classics. The Division did not, as the result of its second audit, require Talbots to file a combined franchise tax report including Classics, or make a conclusion that the license agreement between Talbots and Classics was a sham transaction.

112. As part of its third audit (i.e., the subject audit), the Division's auditor noted that the quality standards set forth in the 1993 License between Talbots and Classics were only four lines long, while in the prior 1988 License between Talbots and Jusco BV, the quality standards were some five pages long and set forth several particular rights and obligations between the parties (***see***, Findings of Fact "11" and "29"). The auditor noted as well that the royalty rate in the 1993 License was 1.8%, that is, higher than the 1.6% set forth in the 1988 License. The Division pointed out that no pricing valuation study was ever provided to substantiate the 1.8% royalty rate. The auditor also was troubled that the 1996 Study was deemed effective as of February 1996, but was dated as of June 30, 1996 and was not delivered to Talbots until August 27, 1997 which is several months after the royalty rate in the 1996 License was amended to 6%. Although the auditor inquired about the timing differences, no information was given to him that an oral opinion advancing a 6% royalty rate had been provided to Talbots by Mr. Reilly. He further noted that during the audit, the Division requested interviews with the part-time individuals working at Classics and sought to visit Classics' offices but was denied in each of such requests. Finally, the auditor noted that, by way of subsequent dividends, Classics sent back to Talbots substantial amounts of money relating to the royalties charged.

113. The following proposed findings of fact submitted by petitioner were rejected or modified for the reasons stated:

(a) proposed findings of fact 2, 13, 72 through 75, 80 through 83, 85, 134, 140, 144, 158, 160, 171, 172, 220 (to the extent of the parenthetical material therein), 225 and 257 are rejected as unnecessary and not relevant or probative with regard to the issues presented for the tax years in question;

(b) proposed finding of fact 149 is rejected as stating a conclusion rather than a finding of fact;

(c) proposed finding of fact 63 is rejected to the extent that it is a repetition of the final sentence of proposed finding of fact 55;

(d) proposed findings of fact 7 and 67 are clarified, respectively, to correctly set forth the dollar amount of tax at issue after the BCMS conference (exclusive of penalty and interest), and to reflect that Talbots (rather than Talbots and Classics) commissioned the 1996 Study.

114. The following proposed findings of fact submitted by the Division were rejected or modified for the reasons stated:

(a) proposed finding of fact 19 is rejected as unnecessary and not relevant or probative with regard to the issues presented for the tax years in question;

(b) proposed finding of fact 171 is rejected as overly broad and not accurately reflecting the record;

(c) proposed finding of fact 224 is rejected as speculative.

SUMMARY OF THE PARTIES' POSITIONS

115. Talbots does not dispute that its royalty payments to its wholly-owned subsidiary, Classics, for the use of the Talbots trademarks pursuant to the licensing agreement between the two entities gives rise to a rebuttable statutory presumption that Talbots' income is distorted such that Talbots must file a combined New York State franchise tax report including Classics so as to realistically and correctly portray Talbots' income. Talbots further acknowledges that it bears the burden of overcoming the presumption of distortion, and thus the requirement or necessity to file a combined report, by showing that its royalty payments to Classics during the years in issue were based on rates which were arm's length rates. Talbots maintains, in turn, that

it has met its burden, arguing that the royalty rate for the first two years in issue was a carryover rate equal to that which was in effect between Talbots and Jusco BV, the entity which held the Talbots trademarks immediately prior to Classics, and that the royalty rate for the last year in issue was determined specifically as the result of a comprehensive study commissioned by Talbots and performed by an expert appraiser pursuant to well recognized and accepted appraisal standards to establish the appropriate arm's length rate for Talbots' license of the Talbots trademarks from Classics.

116. Talbots first asserts that the 1.8% of net sales rate applicable for the first two years in issue (and the resulting deduction for the royalty payments based thereon) was challenged, but not changed, by the IRS during the course of its audit of Talbots for earlier years. Talbots maintains that the relationship and royalty payments between Talbots and Jusco BV were functionally indistinguishable from the relationship and royalty payments between Talbots and Classics, thus supporting the validity of the rate for the first two years as an accepted arm's length rate. Talbots points out that the Division was aware of the IRS audit and result, and had conducted its own audits of Talbots prior to the years in question here (the latter of which audits included a small period of time following Classics acquisition of the Talbots trademarks), but did not seek to combine Talbots and Jusco BV (or Talbots and Classics), thus leading to a conclusion that the Division, at least tacitly, approved the 1.8% rate and resulting payments. Finally, petitioner asserts that the rate for the earlier two years was significantly lower than the rate for the last year in issue, such that, if anything, the royalty rate and resulting payments for the first two years should be considered understated and inuring to the benefit of the Division since Talbots' allegedly understated royalty expense deductions left more of Talbots' income to be subject to New York taxation.

117. Moving to the final year in issue, Talbots argues that the 6% royalty rate results from a comprehensive study commissioned for the specific purpose of determining the appropriate arm's length rate for a license to use the Talbots trademarks. Talbots admits that the rate was determined as the result of a study conducted pursuant to USPAP rather than pursuant to the particular mechanical procedures set forth in the Section 482 Regulations. Talbots asserts, however, that it was not required to perform a study pursuant to the Section 482 Regulations in order to prove the arm's length legitimacy of the royalty rate for the subject license, and that the Division's criticisms that the study which was conducted deviated from the procedures of the Section 482 Regulations are irrelevant to the question of whether the 6% rate was an arm's length rate. Talbots points out that it was concerned with determining a current arm's length royalty rate, and that a USPAP study more suitably fulfilled this current and prospective purpose than would a study conducted pursuant to the Section 482 Regulations which are designed to test, retrospectively, the validity of a chosen rate. Talbots points out that the USPAP standards, if not the precise methods, are consistent with the principles underlying the Section 482 Regulations. Petitioner claims strength in the fact that the USPAP study utilized a number of different primary and confirmatory methods and analyses in arriving at a rate determination, as opposed to a Section 482 Regulations study which is conducted on the basis of one determined "best method." Talbots also points out that the Division has provided no affirmative counter to the validity of the USPAP standards, the manner in which the same were applied, or the 6% rate resulting therefrom.

118. Talbots also argues that having established the validity of the royalty rates and resulting payments as constituting arm's length rates means that there has been a proper reflection of Talbots' income and an absence of distortion of income, thus fulfilling the shared purpose of Tax Law § 211(4) and IRC § 482 and the Section 482 Regulations of assuring the

proper portrayal of income and eliminating any further inquiry concerning combined filing. Talbots argues in this respect that since its income has been properly reflected, the so-called "sham standard" pursuant to which intercompany relationships which have no valid business purpose or economic substance save for tax avoidance will be disregarded, is not applicable. Talbots claims that those cases which have discussed the sham standard have done so as *dicta*, following an analysis and conclusion that the intercompany charges at issue in those cases were not reflective of arm's length pricing, that the taxpayers therein had not met their burden of overcoming the presumption of distortion, and that combined filing was appropriate. Talbots also maintains that to the extent the sham standard may be found to be applicable in this case, it has established that the situation here between Talbots and Classics was entered into for valid business purposes having economic substance, to wit, to provide flexibility for Talbots to grow, to give Talbots the ability to sell geographical rights to the Talbots trademarks to other businesses, and to create a captive revenue stream that could be used as identified collateral for future loans. Finally, Talbots asserts that state tax considerations played no role in the decision that Classics would acquire the Talbots trademarks, that other possible arrangements for ownership of the trademarks would have provided more advantageous Federal and state tax results, and that Talbots paid more Federal and state taxes after Classics became the owner and licensor or the trademarks than before, when Jusco BV owned and licensed the trademarks.

119. It is the Division's position that Classics must be included in a combined report with Talbots because there exists an "agreement, understanding or arrangement" under Tax Law § 211(4), in the form of the sale of the Talbots trademarks and the license agreement between Talbots and Classics, which has caused Talbots' "activity, business, income or capital" within New York to become improperly or inaccurately reflected within the contemplation of the statute. According to the Division, the result of the Talbots' license arrangement with Classics is

to divert taxable income out of New York in the form of excessive royalties paid by Talbots to Classics.

120. The Division first challenges the payments for the initial two years at issue herein, pointing out that no valuation study at all was produced to establish that the 1.8% royalty rate for such years was an arm's length rate. In response to the argument that the same was a carryover rate applied to a situation functionally the same as the prior Talbots and Jusco BV relationship which had been challenged by the IRS and allegedly approved, the Division points out that Talbots business had evolved from carrying only approximately 25% of its own labeled merchandise to a much higher amount of its own labeled merchandise, and was thus significantly different from the circumstances existing in 1988 when the Talbots and Jusco BV license had been initially established. Given this change in Talbots' business, and noting the contributions that Talbots has made and continues to bring to building, maintaining and enhancing the value of the Talbots trademarks, the Division maintains it is "unlikely" that Classics could have commanded of an unrelated licensee a rate of 1.8% of net sales for the first two years at issue. The Division also notes that its inquiries to the IRS resulted in information that intercompany pricing (i.e., the license and royalty payments between Talbots and Jusco BV) had not been an issue in the IRS audit.

121. The Division also questions the inherent reliability of the 1996 Study and the rate determined thereby, most specifically because the 1996 Study did not adhere to the requirements of the Section 482 Regulations. The Division asserted, through its expert witness, that the only way to verify the acceptability of a royalty rate as an arm's length rate is to perform such a Section 482 Regulations study. The Division alleges that the 1996 Study ascribes too much value to the Talbots trademarks as the source or reason for Talbots' excess profits and its outperformance of its peers by failing to properly account for unrecorded increases in the value

of Talbots' other assets or recognize the value of certain unidentified intangible assets possessed by Talbots. In this respect, the Division views Mr. Reilly's split of Talbots' excess profits (after attribution of a share of Talbots' profits to identified tangible and intangible assets) at 50% to the Talbots trademarks and 50% to other unidentified assets without individually attempting to identify and value such latter assets, as arbitrary and unreliable. The Division posits that the 1996 Study, with its use of multiple approaches and information sources, lacks the precision which is afforded through the application of the Section 482 Regulations whereby one "best" method is determined and strictly applied.

122. The Division maintains that the 1996 Study overvalued the Talbots trademarks, and that the same are merely the symbol of a tasteful selection of high quality, classic clothing and a high level of service, provided, paid for and regularly enhanced by Talbots' combination of classic and unique designs, quality products, attractive pricing (value), customer service, store locations, synergies with catalog operations, operating efficiencies and economies of scale. In this regard, the Division argues that nearly all of the activities which would be viewed as building, maintaining and enhancing the Talbots trademarks are, in fact, carried out and paid for by Talbots as opposed to Classics. The Division notes that Talbots provides and pays for strategic planning, clothing design function, locating the best manufacturers, ownership and operation of stores, a distribution and logistics network, determination of store locations and layout, hiring and training of employees, preparation and selective mailing of catalogs and ongoing performance of quality control work. In sum, the Division asserts that the 1996 Study does not properly account for all of this value as driving Talbots' excess profits by attributing a full 50% of such excess profit to the value of the Talbots trademarks, thus leaving all of the foregoing activities and support undervalued relative to their contributions to Talbots' excess profits. The Division maintains that Classics' rate of return and its operating profit are simply

too high for what it provides in return to Talbots, to wit, the functions it performs, assets it employs and risks it assumes. The Division acknowledges the success and growth of Talbots' business and suggests that, taken together, Talbots and Classics might well be able to command a royalty rate of 6% to allow other entities to utilize the Talbots trademarks. However, the Division maintains that in light of the benefits that Talbots brings to the value of the trademarks, and the expenses incurred in generating such value, a potential unrelated licensee bringing such activities and benefits would seek a much lower royalty rate which reflects the importance of its contributions to the value of the trademarks. Thus, the Division concludes it is "unlikely" that Classics could command, or that an entity like Talbots would be willing to pay, a royalty rate of 6%. The Division further acknowledges that it provided no valuation study of its own on audit, either pursuant to the Section 482 Regulations or otherwise, to determine an arm's length royalty rate, and that therefore it can not state that the royalty rates presented in this matter are clearly incorrect. Nonetheless, the Division maintains that the inconsistencies and shortcomings it has identified in Talbots' reasons for justifying such rates, including the criticisms of the 1996 Study, establish that Talbots has failed to meet its burden of proving that such rates were arm's length rates and has thus failed to rebut the presumption of distortion resulting from its relationship with Classics.

123. The Division also argues that regardless of the propriety of the royalty rate, the record fails to bear out that placing ownership of the Talbots trademarks in Classics was for valid business purposes or had economic substance apart from providing a means of state tax avoidance. On this point, the Division looks to the documented tax reasons including, specifically, the state tax reasons for the manner in which the transfer of ownership of the trademarks was structured. The Division also points to the absence of any written memorializations of the other, i.e., business or economic, reasons supporting the transfer of the

Talbots trademarks to Classics as were advanced in testimony at hearing. The Division notes the manner in which Classics conducts business, including the apparent lack of any quality control or other significant trademark-related activities, or incurring of any expenses with regard thereto (e.g., advertising or catalog expenses), and the extent and nature of the trademark enhancement related activities performed by Talbots. Finally, the Division points to the flow of funds from Talbots to Classics, that is the deductible royalty payments, followed by the return thereof to Talbots in the form of loan repayments of principal (nontaxable) and interest, and dividends (non taxable), as supporting the conclusion that the viability of Classics should be disregarded for New York State tax purposes.

124. In response, Talbots reiterates its arguments that the 1.8% rate for the first two years in question was the same as that charged between Talbots and Jusco BV, that apart from their places of incorporation the relationship of these two entities was functionally identical to Talbots and Classics, and that the direct testimony of Talbots director of taxes was that the deductions based on such royalty rate had been challenged on audit for earlier years by the IRS and had been approved. As to the 6% rate for the third year in issue, Talbots goes on to note that the 1996 Study was a comprehensive, reliable and valid study, appropriately conducted by a competent expert appraiser in compliance with the relevant standards of USPAP, such that the royalty rate determined as a result thereof must be accepted as an arm's length rate. Talbots again states that there is no requirement that in order to be acceptable and overcome the presumption of distortion, a royalty rate study must be one conducted pursuant to the Section 482 Regulations. Talbots points out that the Division has not come forward with any showing that the USPAP standards, pursuant to which the 1996 Study was conducted, are invalid or unreliable or were applied by Mr. Reilly in any manner inconsistent with USPAP requirements. On this score, Talbots notes that the Division's expert witness admitted he was not sufficiently

familiar with USPAP standards to opine on the same. Talbots asserts that the evidence from all of the sources looked to by Mr. Reilly's support the conclusion that the royalty rate should be on the high end of the ranges resulting from the methods of analysis applied in the 1996 Study. Talbots also argues that the 1996 Study did not combine or conflate the operations of Talbots and Classics in arriving at its indicated royalty point rate. Talbots maintains that appraisers are required to exercise their professional judgement, based on their training, expertise and experience, in numerous situations, and that the 50% profit split represented such a judgement by Mr. Reilly which was not only permissible but was supported by the evidence and was, if anything, conservative in light thereof. Talbots notes that the difference between the contribution to excess profit in 1993 (67% Talbots and 33% Classics) versus that in 1996 (50% Talbots and 50% Classics), as set forth by Mr. Reilly, results from an ongoing climb in the relative value and contribution to profit provided by the Talbots trademarks, as borne out by his functional analysis which reflected better name recognition, customer demographics, and the like over time.

125. Finally, Talbots again asserts that if a royalty rate is an arm's length rate, then the sham standard has no application, and that in this case the arm's length propriety of the rates in question have been established. Talbots also maintains that, even if the sham standard may be invoked (i.e., regardless of the propriety of the royalty rate), the Division has advanced only speculation, based primarily on the July 9th Presentation Document, that the structure under which the Talbots trademarks were held was based solely on state tax considerations. Talbots argues that the Division's speculation in this regard does not overcome the testimony to the contrary offered by Talbots' chief financial officer and its director of taxes. Thus, Talbots asserts that the Division has not met its burden of establishing that the validity of the relationship between Talbots and Classics should be disregarded for state tax purposes.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law § 209[1]). The franchise tax is based on the taxpayer's entire net income ("ENI"). ENI is generally the same as the taxpayer's Federal taxable income with certain modifications, and consists of two components, business income and investment income. Business income is equal to ENI less investment income (Tax Law § 208[8]), and is allocated to New York State by multiplying the taxpayer's business income by its business allocation percentage ("BAP") as defined in Tax Law § 210(3)(a).

B. In order to properly reflect a taxpayer's franchise tax liability, Tax Law § 211(4) gives the Division the discretion to require or permit corporations subject to New York State franchise tax to file combined reports with certain other corporations. The statute requires that the taxpayer either own or control substantially all of the stock of the other corporations, or the taxpayer's stock be substantially owned or controlled by such other corporations. The statute further limits the Division's discretion by providing that

> no 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 to properly reflect the tax liability under this article . . . . (Tax Law § 211[4].)

C. The Division's regulations provide that it 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 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] [emphasis added]).

Substantial intercorporate transactions exist "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])."

D. There is no dispute between the parties that Talbots meets the foregoing three conditions pursuant to which combined reporting may be required: (1) Talbots owns all of the capital stock of Classics, (2) Talbots and Classics are part of a unitary business, and (3) the royalty payments from Talbots to Classics are substantial intercompany transactions. However, combination may not be required where a taxpayer submits evidence sufficient to establish that the intercompany transactions, here the royalty payments from Talbots to Classics, were based on arm's length royalty rates, so as to rebut the presumption of distortion. Talbots admits that it has the burden of proof in demonstrating that the transactions between it and Classics were at arm's length (***Matter of USV Pharm. Corp.,*** Tax Appeals Tribunal, July 16, 1992; ***Matter of Standard Mfg. Co.,*** Tax Appeals Tribunal, February 6, 1992).

E. In addition to the issue of whether the royalty payments were at arm's length, and thus did not distort income, the Division also asserts that Talbots' license agreement with Classics lacked economic substance, and that Classics was formed strictly for tax avoidance purposes, a position that Talbots vigorously contests. There is no dispute that if a taxpayer fails to establish that its intercompany transactions were at arm's length, and thus does not rebut the presumption of distortion, then combination will follow notwithstanding the business and economic validity of the underlying intercompany structure. At the same time, even if the intercompany payments are at arm's length, there must still be a business purpose and economic substance to the intercompany arrangement, for if the intercompany arrangement has no economic substance or business purpose apart from tax avoidance the same will properly be disregarded (***Matter of The Sherwin-Williams Company***, Tax Appeals Tribunal, June 5, 2003, ***confirmed*** 12 AD3d 112, 784 NYS2d 178). The Division does not dispute that it has the burden of establishing, both in cases where the taxpayer has rebutted the presumption of distortion and in nonpresumption (i.e., business purpose and economic substance) cases, why reporting on a separate basis does not properly reflect income (***Matter of Silver King Broadcasting of N.J., Inc.***, Tax Appeals Tribunal, May 9, 1996). While there are thus two separate bases upon which to consider whether combined reporting is necessary, in either instance the fundamental question remains whether " . . . under all of the circumstances of the intercompany relationship . . ., combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income" (***Matter of Standard Mfg. Co. v. Tax Commn. of State of N.Y.***, 114 AD2d138, 141, 498 NYS2d 724, ***affd*** 69 NY2d 635, 511 NYS2d 229).

F. In deciding ***Matter of The Sherwin-Williams Company (supra)***, the Tax Appeals Tribunal first addressed the issue of the business purpose and economic validity of assignment and license-back agreements between Sherwin-Williams and two of its subsidiaries. Thereafter, the Tribunal addressed the issue of whether an appraisal report submitted by Sherwin-Williams established that the payments made pursuant to such intercompany arrangements were at arm's length. The Tribunal concluded that the assignment and license-back agreements lacked any business purpose or economic substance apart from tax avoidance, and further concluded that the royalties paid by Sherwin-Williams pursuant to such license agreements did not reflect arm's length rates. On appeal, the Appellate Division confirmed the Tribunal's determination that the intercompany arrangement, the assignment and license-back agreements, lacked any business purpose and economic substance.

The Court held:

> the Tribunal's determination that petitioner failed to rebut the presumption of distortion since the assignment and license-back transaction lacked a business purpose or economic substance apart from tax avoidance is supported by substantial evidence . . . . Having found substantial evidence to support the Tribunal's determination of a lack of a business purpose and economic substance, it is not necessary to address the *separate* ground of whether the royalty rates reflected market rates (***Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal,*** 12 AD3d 112, 118, 784 NYS2d 178, 184; emphasis added).

From this holding, it follows that if the Talbots and Classics intercompany arrangement lacked a business purpose and economic substance apart from tax avoidance it is then, strictly speaking, unnecessary to determine whether the intercompany royalty rates reflected arm's length rates. Thus, contrary to petitioner's assertions, a showing that the royalty payments resulted from arm's length rates does not foreclose the issue of whether the income of the taxpayer was or was not distorted, nor was the Tribunal's analysis and conclusion in ***Sherwin-Williams*** concerning the economic validity and business purpose of the arrangement under which the intercompany payments occurred merely *obiter dictum*. Distilled to its essence, the principle is that regardless of the arm's length validity of the royalty rate, absent some valid business purpose or substantive economic justification apart from tax avoidance underlying an intercompany structure or arrangement, the same will be viewed only as a tax avoidance device and will properly be disregarded (***Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal, supra.***). Thus, this matter first turns on the legitimacy of the Talbots and Classics structure and licensing arrangement itself, and a determination of whether the same was merely an income shifting arrangement instituted and carried out simply for the tax advantages flowing therefrom, rather than for legitimate and substantial business purposes having economic validity.

G. In addressing the economic substance and business validity issue, the Tribunal and the Court in ***Sherwin-Williams*** discussed the two-prong test of ***Frank Lyon Co. v. United States*** (435 US 531, 55 L Ed 2d 550), where the Court analyzed the criteria used to determine whether transactions between controlled corporations had both a valid business purpose and economic substance. Such analysis focuses on whether there existed a "transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached" (***Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal, supra.***, ***citing Frank Lyon Co. v. United States, supra.***, at 583-584). The focus of the business purpose test is the subjective motive of the taxpayer for choosing to become a party to the transaction, that is whether the transaction is motivated by no business purpose other than obtaining tax benefits, while the economic substance inquiry is concerned with whether the substance of the transaction reflects its form, and whether there exists a reasonable possibility of profit apart from any tax benefit (***Bail Bonds by Marvin Nelson, Inc. v. Commissioner***, 820 F2d 1543).

H. The first critical aspect in analyzing the transaction in question is to distinguish the broad purpose behind bringing the trademarks back into the "ownership *or* control" of Talbots, from the particular structure chosen to carry out such purpose, i.e., discerning why Talbots chose to create and use a wholly-owned domestic intellectual property holding subsidiary as the vehicle in which ownership of the trademarks would be placed as opposed to placing ownership directly in Talbots. The record is clear and neither party disputes that the broad purpose or reason behind purchasing the trademarks from Jusco BV was to "best effect" the Talbots' IPO, that is to maximize the value of the Talbots stock to be offered for sale to the public. This reason is set forth in the July 9th Presentation Document and is described at Findings of Fact "18" and "19". That Talbots could have purchased the trademarks from Jusco BV and simply held the trademarks thereafter is similarly not in dispute. The July 9th Presentation Document states that it is "critical to the successful marketing of [the IPO]" that Talbots "own *or* control" the trademarks. The Document then goes on to analyze the purpose and benefits of structuring the transaction using a subsidiary corporation to hold the trademarks. While Talbots claims that the main purpose was to return the trademarks *specifically to* a domestic intellectual property holding company in order to maximize the value of Talbots' stock at the time of its IPO, the main purpose was more broadly and simply to return ownership *or* control of the trademarks to Talbots so as to maximize the stock value. This "either/or" proposition leaves clear that, for purposes of the IPO, *either* direct ownership of the trademarks by Talbots *or* control of the trademarks by Talbots through a subsidiary, the stock of which was owned by Talbots, accomplished the same main purpose, to wit, gaining for Talbots (and its new shareholders) ownership *or* control over the trademarks. Thus, the issue does not turn simply on the business or economic reasons for returning the trademarks to Talbots, but rather on the business or economic reasons, *if any*, for choosing to do so by placing ownership of the trademarks in a domestic intellectual property holding company as opposed to directly in Talbots. The July 9, 1993 Presentation Document does not discuss the "marketing issues" concerning the IPO, but instead simply states that the same have been "extensively discussed" (***see,*** Finding of Fact "19"). The record reveals no anticipated detriment to the success of the IPO regardless of which option, either direct ownership in Talbots or control thereof through a subsidiary, was chosen. Thus, the specific question is not whether moving the trademarks into Talbots ownership or control was for valid business and economic purposes (it concededly was), but rather whether some business or economic purpose beyond tax avoidance was served by placing ownership of the trademarks in Classics.

I. The clearest statement specifically explaining why the trademarks should be owned by Classics (and controlled by Talbots) rather than owned by Talbots is set forth in the July 9, 1993 Presentation Document, which recites (1) the minimization of state and local taxes and (2) the ability to facilitate any future sale of Talbots, if desired by Jusco, without disrupting the trademark purchase structure recommended (***see***, Finding of Fact "19").[13] These two stated reasons dovetail in light of the fact that there is no information furnished to explain how Jusco would be better able to sell its interest in Talbots in the future if the trademarks were placed in a wholly-owned subsidiary as opposed to held by Talbots itself. The most obvious conclusion to be drawn, however, is that with the trademarks owned by a subsidiary from which a state tax benefit results, Jusco could sell its interest in Talbots at some future point, if desired, without disruption of that very trademark purchase structure and the attendant loss of the state tax benefit derived therefrom. That is, the state tax benefit provided by the recommended ownership structure remains available to a purchaser, thereby maximizing the (future) selling price of Talbots. The significance of being able to sell Talbots in the future, without disrupting the trademark purchase structure recommended, is thus made clear by discerning the reason for recommending such trademark purchase structure in the first place, to wit, the minimization of state and local taxes. Put directly, it is the specifically recommended trademark purchase structure sought not to be disrupted (by a future sale) by which state and local taxes are avoided. This conclusion, however, does not speak at all to any nontax (i.e., business or economic) purposes for choosing such structure.

J. The two reasons articulated in the July 9th Presentation Document are preceded by the statement that it is "imperative" to put the trademarks back into Talbots in the "most economically advantageous structure available." The terms "optimal economics (i.e., significant tax savings)" and "most economically advantageous structure" are certainly analogous in the context of this matter. Although the initial separation of the trademarks and their placement in Jusco BV seems to have been motivated most strongly by Federal as opposed to state tax

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[13] This recitation is consistent with the stated reason for which the trademarks were originally separated from Talbots at the time of Jusco USA's acquisition of Talbots, i.e., "to provide 'optimal economics (i.e., significant tax savings)'."

advantages (***see,*** Finding of Fact "8"), there nonetheless clearly existed state tax benefits from such separation. Thus, while Talbots pays more Federal tax under the current structure than when Jusco BV held the trademarks, this change would appear to be more a function of moving the trademarks to the United States than a function of how the trademarks were held in the United States (i.e., by the subsidiary Classics as opposed to directly by Talbots itself). In turn, while the Federal tax advantage may have decreased upon bringing the trademarks into the United States, the state tax advantage nonetheless remained fully available depending upon the form of ownership chosen for the trademarks. Interestingly, while the record contains significant written information concerning the manner in which Classics should be set up in order to satisfy the standards and inquiries of state tax authorities, and describing the state tax benefits resulting therefrom (***see***, Findings of Fact "19", "23" through "27"), it is essentially devoid of any written information as to the business or economic reasons and purposes underlying the choice to place ownership of the trademarks in Classics. The record here includes no minutes from any meetings of the respective boards of directors that lay out the business or economic reasons for creating Classics or for the transfer of the valuable Talbots trademarks to Classics. A plethora of information regarding the method and means, and resulting state tax benefit, of placing the trademarks in Classics, compared to the absence of any written information identifying any other business or economic benefits of doing so, is certainly consistent and supportive of the conclusion that this manner of structuring the transaction was chosen only for state tax avoidance purposes. It is not surprising, given Talbots' level of sophistication, that the state tax implications of such a choice would be analyzed by petitioner's director of taxes and memorialized in written form. It is, however, surprising, given petitioner's resolute position herein that the decision to place the trademarks in Classics rather than in Talbots was for valid business and economic purposes apart from tax considerations, that the tax implications would be the only matters memorialized in writing. As to the specific writings, it is significant that the August 17, 1993 memorandum (***see,*** Finding of Fact "24") provides that Classics was specifically established in Illinois to "avoid taxation in Massachusetts and other non-unitary states." The August 20, 1993 memorandum (***see,*** Finding of Fact "25") provides that Classics "is not going to be able to use the large sums of cash it is going to receive as royalty payments." While Talbots attempts to minimize the significance of these memoranda based on their timing, and notes that the record does not establish whether the July 9th Presentation Document was ever "presented," it remains that the same, taken together, set forth the clearest picture of why the subsidiary trademark purchase structure was chosen. The memoranda are replete with analysis as to the importance, for state tax purposes, of making Classics appear independent and structured for legitimacy. There are no similar written documents in the record touting or specifying the business or economic benefits, as opposed to the tax benefits, of using a subsidiary to hold the Talbots trademarks. It only stands to reason that if such documents were in existence, they would have been prominently featured in the record.

K. The three stated business or economic reasons for having the trademarks owned by Classics as opposed to directly by Talbots, as revealed in the record, come from the testimony of Talbots chief financial officer, Edward L. Larsen, and are (1) to provide Talbots with flexibility to grow its business geographically and through the establishment of new product lines; (2) to provide Talbots the ability to sell geographical rights to the Talbots trademarks to other businesses, if desired, and (3) to create a captive (or identified) revenue stream of royalty payments that could be used as ready collateral for future loans (***see,*** Finding of Fact "20"). This latter reason was noted in the context of the change, as the result of the IPO, in Talbot's relationship with Jusco Ltd., the Japanese corporation which had previously guaranteed loans made to Talbots by Japanese banks. However, there is nothing in the 1993 License agreement, or in the manner in which Talbots and Classics were operated, post-IPO, which supports the reasons advanced in the testimony given by Mr. Larsen for choosing Classics as the owner of the trademarks. The first two stated reasons were not further explained, nor is there any obvious basis upon which to conclude that ownership of the trademarks by Classics, as opposed to Talbots, somehow better allowed for either of these two purposes (geographic and product-line business expansion, and trademark licensing to other businesses in other geographic locations) to be accomplished. With regard to the third articulated purpose, while the level of Jusco Ltd.'s ownership of Talbots decreased as the result of the IPO, it still, via its 100 percent ownership of Jusco USA, controlled some 63.4% of Talbots' stock. There is no claim or evidence that the royalty stream was used as a means to secure any financing. Rather, it appears that the Japanese banks continued to lend to Talbots in the same manner as before the IPO (***see,*** Finding of Fact "20").

It is particularly noteworthy that the 1988 License, with Jusco BV as licensor, specifically set forth quality standards (at paragraph "2" thereof) covering some four pages and reserving to Jusco BV numerous rights and powers including, among others, the right to have access to inspect each store and other facility at which the licensed items are designed, manufactured or sold, to review licensed services and advertising materials, including the right to review and veto marketing plans and catalogs prior to their implementation and to approve product samples, and to require the production of specifications and test data relating to licensed products. In contrast, the 1993 License, with Classics as licensor, set forth quality standards (at paragraph "2" thereof) in one sentence, providing simply that "Licensor seeks to ensure, and each Licensee undertakes to maintain, the highest standards of quality with respect to all goods and services of each Licensee utilizing the Trademarks" (***compare,*** Findings of Fact "11" and "29"). The extensive reservation of specific rights and powers by Jusco BV, the former licensor, at a minimum speaks favorably to the business and economic legitimacy of the relationship between Jusco BV and Talbots. The contrast shown by the absence thereof in the1993 License between Classics and Talbots does nothing to enhance the claim of business purpose or economic legitimacy in the relationship between Classics and Talbots.

L. Under the sham transaction doctrine, a transaction will be disregarded if it has no economic substance or business purpose other than the creation of tax benefits (***see, United Parcel Service v. Commissioner of Internal Revenue***, 254 F3d 1014, 1018; ***Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal, supra***.). As the Tribunal observed in ***Matter of Sherwin-Williams Company (supra.)***, "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' (***citing Helvering v. Lazarus & Co.,*** 308 US 252, 255)."

In ***Matter of Sherwin-Williams Company (supra.)***, the Tribunal found that the functions of Sherwin-Williams had not changed after the assignments and license-back of the trademarks, despite the fact that the licensing agreements afforded the two trademark holding subsidiaries substantial decision-making authority respecting such areas as advertising, quality control, third-party licensing and trademark litigation. The Tribunal also found that the lone employee and the officers of the trademark holding subsidiaries lacked any meaningful trademark experience, experience in managing branded products or experience in the paint industry. The Tribunal noted that any business arrangement which separated responsibility for trademarks and brand management from those in the company who worked with its branded products on a daily basis would expose the business to serious economic risk. This, the Tribunal determined, explained the absence of a change in the functions of Sherwin-Williams after the licensing agreements became effective, and supported its conclusions that the form of the Sherwin-Williams assignments and licensing transactions did not match their substance. Here, the Talbots trademark asset transfer and licensing transaction, exhibits a similar disconnect between the form of the transaction and its substance. The record provides essentially no information showing that after the creation of Classics in 1993 and on through the tax years at issue, Classics performed any trademark services of consequence, leading to a conclusion that Talbots simply performed the duties of a trademark service provider. There is no evidence to establish that Classics' officers, directors, or its two independent part-time employees had, or engaged in, any meaningful trademark management or quality control responsibilities or activities. The persons within the Talbots organization who actually made the day-to-day decisions respecting brand management, store and catalog operations, manufacturing, marketing and merchandising, which were the core activities of Talbots, and which undeniably served to enhance the value of the trademarks, were employees of Talbots. As in ***Sherwin-Williams***, the functions carried out by Talbots did not change after the transfer vesting ownership of the Talbots trademarks in Classics and the license thereof to Talbots. In fact, the licensor's (Classics) obligations, powers and authority over such functions decreased in comparison to such obligations, powers and authority as were held by Jusco BV when it owned the trademarks (***compare*** Findings of Fact "11" and "29").

M. The record reveals that no compensation was paid to the officers or members of the board of directors of Classics for fulfilling such roles. The record also reflects that the two part-time persons who worked for Classics carried out essentially ministerial functions, and there is no evidence of what, if any, trademark work was performed by or on behalf of Classics. There is no evidence of any third-party independent licensing of the trademarks by Classics to others, nor of any quality control work or influence exercised over the trademarks by Classics. There is no evidence that Classics, or outside legal counsel retained by Classics, performed any trademark management, protection or other functions, approved any new trademarks, registered any new trademarks or renewed any registered trademarks, or engaged in any trademark infringement or other litigation. All product research, development, manufacturing, distribution, store development, catalog creation and mailing, customer listing and information gathering and maintenance, product sales and advertising expenses (during the audit period) were borne by Talbots.

The August 20 memorandum (***see***, Finding of Fact "25") and its recommendation to establish the trademark subsidiary (Classics) in a "Unitary State since they will tax the company's profits anyway no matter how it is structured" leads clearly to the conclusion that the nonunitary states would not tax the income if the corporation is properly structured and operated (i.e., clothed in the appearance of economic and business validity). In fact, the series of memoranda (***see***, Findings of Fact "23 " through "26 ") all point to the tax purposes behind creating Classics. Talbots notes that all, except for the first of such memoranda, post-date the July 3, 1993 Presentation Document, and stresses the testimonial claim by Mr. Larsen that he alone made the decision to utilize a subsidiary to own the trademarks, that he did so prior to seeking an analysis of the state tax benefits which might result therefrom, and that such memoranda should therefore be accorded little weight. As noted earlier, it is not surprising that such memoranda would concentrate on tax issues, given that their author was Talbots' director of taxes. However, at the same time, it strains plausibility to accept that these "after-the-fact" written memorializations were the first state tax thoughts and analysis given to the issue of direct ownership of the trademarks by Talbots versus ownership and control via the use of a wholly-owned subsidiary, or that state tax considerations played no role in the decision. The record simply does not support this conclusion.

The fact that the written comments and tax analysis postdate the decision to use a subsidiary is no different from the situation where the Willamette written report postdates the decision to amend the license agreement and increase the royalty rate paid by Talbots to Classics (***see,*** Finding of Fact "92"). It is also telling that the numerical presentation set forth in the August 18, 1993 Talbots Trademark Analysis (***see,*** Finding of Fact "26") lays out the excess state tax benefit of utilizing a subsidiary corporation. The incorporation of Classics occurred on October 23, 1993, i.e., well after the memoranda concerning the structure and tax benefit of utilizing a subsidiary were written. The choice to utilize Classics to purchase the trademarks certainly could have been arrived at by Mr. Larsen prior to the series of memoranda being written, with such memoranda serving mainly as a guide to the recommended steps to be taken to cloak Classics with the appearance of business and economic validity apart from tax considerations. However, in light of the July 9, 1993 Presentation Document which reflects state and local tax savings as the objective and result of using a domestic intellectual property holding corporation, his choice was certainly not made "in the dark" with regard to state tax considerations. The conclusion to be drawn is that the Talbots' management team responsible for deciding how to effect the purchase of the trademarks was made acutely aware of the state tax benefit of doing so via a subsidiary corporation. The decision to place the Talbots trademarks in a wholly-owned subsidiary was not one from which ancillary or coincidental state tax benefits resulted but was, as the record bears out, a conscious decision the overriding purpose of which was state tax avoidance as opposed to business or economic purposes.

Even assuming the royalty rates in this case are determined to have represented arm's length rates, the simple question remains as to why Talbots chose to pay for the use of trademarks which it supports and which embody a large part of its success. The essential question, given all that Talbots provides to manage and enhance the value of the trademarks (and assuming that such accounts for only 50% of the excess profits as determined by Mr. Reilly) in comparison to the lack of any apparent significant reciprocal services or benefits provided to Talbots by Classics, centers on why Talbots would choose the structure present here and pay a captive subsidiary for the use of the trademarks apart from the state tax benefit resulting therefrom. Talbots asserts that if the royalty rates are accepted as arm's length rates, i.e., that an unrelated company otherwise resembling Talbots in its operations but not possessing valuable trademarks to affix to its products would pay the subject rates to license such trademarks, then there is no distortion of income and the sham standard simply does not apply. This assertion is rejected. Unlike Talbots, which already controls the trademarks through its ownership of Classics, an unrelated company would have the business and economic reasons of needing to obtain the use of the trademarks it did not own or control.

N. The tax related reasons for the purchase and license-back transaction here include a loan from Talbots to Classics to finance the purchase of the trademarks, Talbots' tax deductible payment to Classics of royalties for use of the trademarks, followed by Classics' repayment to Talbots of principal and interest on the loan. The payment by Classics of tax-free dividends back to Talbots is also an important tax related feature of the transaction. This type of circular flow of funds among related entities is an indication of a transaction lacking in economic substance (***Merryman v. Commissioner of Internal Revenue***, 873 F2d 879).

The relative importance to Talbots of the tax related reasons, compared to the alleged business related or economic reasons for the transaction is revealed by the fact that the "consensus" concerning how to structure the return of the trademarks, i.e., by using a domestic subsidiary corporation, lists state and local tax savings as the prime reason. It is obvious that the royalty payments made by Talbots to Classics for the use of the trademarks did not include any payment for services provided by Classics because Classics provided no apparent services to

Talbots as its licensee. Classics' profit, in light of what it provides Talbots in return, only underscores the appropriateness of concluding that the sham transaction standard is applicable in this case. In fact, the entire transaction is suffused with tax considerations. Even if Talbots can meet its burden to prove that the royalties it paid to Classics were based on arm's length rates, the Division has carried its burden to establishing that the purchase and license-back transactions had no business purpose apart from tax avoidance, lacked economic substance other than the creation of tax benefits, and that the royalty payments made to Classics were a contrived mechanism to limit Talbots' exposure to state franchise taxes (***see, Syms Corp. v. Commissioner of Internal Revenue,*** 436 Mass 505, 765 NE2d 758). No one disputes that tax minimization is clearly acceptable as a legitimate aim and exercise, and that tax "ramifications" are properly considered with respect to "all business transactions as a matter of ordinary business prudence" (***see, G.D. Searle & Co. v. Commr.***, 88 TC 252, 365). However, at the same time, it is not acceptable to manufacture tax deductions by the simple expedient of having no legal impediment against creating an extra-jurisdictional subsidiary entity, the only discernable purpose for which is to accept money and then send it back in a tax advantaged circuitous flow (***see, Merryman v. Commissioner of Internal Revenue, supra.***). The nontax business and economic reasons advanced here in favor of the legitimacy of Classics are thin at best and leave no sense of any business or economic purpose of any real consequence. Accordingly, the notices of deficiency are sustained to the extent that the same result in the imposition of tax premised upon combining Talbots and Classics for purposes of the filing of New York State corporation franchise tax reports for the years in question.

O. Given the foregoing conclusion that the intercompany arrangement between Talbots and Classics should be disregarded for New York State tax purposes, the issue of whether petitioner has established that the 1.8% (for FY 1994 and FY 1995) and 6% (for FY 1996) royalty rates were arm's length rates is rendered moot. However, for purposes of affording a two-tier level of review of this issue, if it is found that the use of Classics as the owner of the trademarks was for valid business and economic purposes apart from state tax avoidance, petitioner has met its burden of establishing that the respective rates upon which the royalties were computed were arm's length rates. The basis for this determination is discussed hereafter.

P. As a preliminary matter, the parties spend some effort in arguing about the impact of certain prior audit activities by both the Division and the IRS (***see***, Findings of Fact "105" and "106"). These arguments include Talbots' claim that upon audit the IRS challenged, but did not change or disallow, the deductions taken for Talbots' royalty payments to Jusco BV, and that such audit result validates the arm's length status of the 1.8% royalty rate for the first two years in issue. The Division's claim, in contrast, is that its inquiries to the IRS on this question resulted in advice that "intercompany pricing was not an issue" in the IRS audit. Talbots also notes that in its prior audits of Talbots the Division did not pursue its own policy of combining affiliated companies meeting the requirements for combination, and made no conclusion that Talbots' relationship with Classics was a sham. In response, the Division averred to its belief that combination including Jusco BV was not possible since Jusco BV was an alien corporation and that the period for which combination with Classics would apply would be short, the resulting dollar amount would be relatively small, and that another audit would be occurring shortly.

Q. There is no compelling or even clear evidence concerning the degree or scope of the audit examination regarding intercompany pricing as undertaken by the IRS, and certainly no evidence that the same involved an IRS study pursuant to the Section 482 Regulations. On this score, there was nothing specific in Ms. Grady's testimony concerning the scope or depth of the IRS challenge to or investigation of the deductions for royalty payments made by Talbots to

Jusco BV. The absence of an audit change for prior years does not affirmatively establish the validity of or bind the parties to the rates or payments for the (subsequent) years in issue here, or support a conclusion that the same meets Talbots' burden of proof that 1.8% was an arm's length royalty rate for FY 1994 or FY 1995.[14] Similarly, the fact that the Division did not, in earlier audits, combine Talbots with Jusco BV because of its own view that it was legally constrained from doing so, and did not combine Talbots with Classics because the period would be short and the dollar amount would be small or because another audit would be occurring, neither establishes affirmatively the validity of the royalty rate for the earlier years nor bars combination in later years (as occurred here). On balance, the assertions raised with regard to the prior audit activities are inconclusive with respect to the question of the validity of the royalty rates, leaving the best conclusion to be that the royalty payment deductions, for reasons not fully or clearly articulated, were simply not disallowed by the IRS.

R. Turning to the validity of the royalty rates, a critical distinction in this case is that the IRS in fact performs valuation audits of intercompany pricing agreements pursuant to IRC § 482 and the Section 482 Regulations promulgated thereunder, so as to test and determine the validity of such agreements under arm's length standards. The Division has not performed such an audit, nor made any such "examination-based" assessment of the validity of the intercompany pricing agreement here (the royalty rate between Talbots and Classics), but rather has relied upon the presumption of distortion set forth under the Tax Law. Talbots, for its part, has presented its comprehensive study of the intercompany arrangement, which forms the basis upon which the royalty rate, at least for FY 1996, was set. The Division points out alleged inadequacies therein, centered primarily on the proposition that such study was not conducted pursuant to the

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[14] A stronger conclusion supporting this rate may, in fact, be drawn from the results of the 1996 Study and its change to a 6% royalty rate (***see***, Conclusion of Law "X").

standards of the Section 482 Regulations. The unspoken premise is that without such a study, the rates in issue cannot be considered "substantiated" as arm's length rates.

S. The Tax Appeals Tribunal and the courts have clearly endorsed reliance on the results of studies specifically conducted pursuant to the Section 482 Regulations, and have also endorsed the application of the *principles* of the Section 482 Regulations in the absence of a study conducted pursuant to the specific procedures thereof, to determine the arm's length validity of intercompany pricing arrangements. Specifically, such reliance has been accepted in the following situations:

> (1) To test, through cross checking by reference to the Section 482 Regulations, whether a purported section 482 study in fact complied with the procedures of such regulations (***Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal, supra.; Matter of Tropicana Products Sales, Inc***., Tax Appeals Tribunal, June 12, 2000 [concluding that it did not]);
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> (2) To conclude that an IRS section 482 study, including the adjustments resulting therefrom, can serve to establish that intercompany transactions were conducted at arm's length (***Matter of Silver King Broadcasting of N.J., Inc., supra.; Matter of Medtronic***, Tax Appeals Tribunal, September 23, 1993; ***Matter of USV Pharm. Corp., supra***.; and
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> (3) To conclude, in the absence of a section 482 study, that reliance may be made on the principles of IRC § 482 and the Section 482 Regulations (as opposed to the mechanical procedures involved in conducting a study pursuant to such Regulations) to evaluate whether a royalty rate or price is at arm's length (***Matter of Sears, Roebuck & Co.***, Tax Appeals Tribunal, April 28, 1994; ***Matter of Campbell Sales Co.***, Tax Appeals Tribunal, December 2, 1993 [the Tribunal will apply section 482 principles in the absence of Federal section 482 adjustments]).

As noted at "3" above, the Tax Appeals Tribunal has clearly endorsed reliance on the results of studies conducted pursuant to the Section 482 Regulations and to the application of the *principles* of the Section 482 Regulations. In so doing, however, neither the Tribunal nor the courts have adopted a rule that the only means to validate a given intercompany pricing arrangement is to conduct a study pursuant to the Section 482 Regulations, or that a properly conducted USPAP (or other) study is not sufficient to establish such validity. Pointing out where a USPAP study deviates from the specific procedures of the Section 482 Regulations alone does not invalidate the USPAP study or result. In fact, the parties through their respective expert witnesses specifically agree that the results of a study conducted per USPAP and a study conducted per the Section 482 Regulations could coincide in their results (***see,*** Finding of Fact "98"). There is no argument or evidence that the 1996 Study deviated from USPAP criteria in application method and rules, or that the resulting 6% rate was incorrect *per se*. The Division makes no specific assessment of the validity of the royalty rate, largely because the Division has itself conducted no "audit" of the actual validity of the intercompany pricing agreement. Without more, such as a showing of invalidity in either the USPAP procedures or in their application, it cannot be concluded that the resulting 6% rate is invalid.

T. The Division's primary objection, as noted, stands on the flawed premise that only a study which adheres to the Section 482 Regulations can be considered reliable enough to establish the validity of a given intercompany royalty rate and payment. This objection is rejected. Since the 1996 Study does not purport to be a report prepared pursuant to the Section 482 Regulations, its conformity or nonconformity with the *procedures* of the Section 482 Regulations is largely unimportant. What is important is whether the 1996 Study applies the *principles* of IRC § 482, for the Tribunal has made it very clear that it will be guided by the *principles* of IRC § 482 in determining whether intercorporate transactions result in distortion (***see, Matter of Sears Roebuck & Co., supra.***).[15] Here, there is agreement that although the

[15] Talbots argues that there is no mandate that it conduct a valuation study pursuant to the Section 482 Regulations because the companies involved are both domestic entities. While this is true, it remains that the (Federal) case of a domestic U.S. taxpaying entity and a foreign (non-U.S. taxpaying) affiliated entity, under which circumstances the IRC § 482 rules apply, is essentially the analog to the (State) case of a domestic New York taxpaying entity and a foreign (non-New York taxpaying) affiliated entity. In each instance, it is the appropriateness of the amount of income available for taxation which is in question. Thus, clearly, the principles underlying the Section 482 Regulations are relevant and useful to the New York situation, and the relevant case law recognizes as much.

USPAP analysis underlying the 1996 Study did not follow precisely the procedures of the Section 482 Regulations, it did apply and was conducted in a manner consistent with the principles of the same (***see,*** Finding of Fact "66"). This supports Talbots' contentions that the royalty rate determined therefrom was an arm's length rate and that the royalty payments based thereon did not, at least in dollar amount, distort Talbots' income within the meaning of Tax Law § 211(4).[16] While the Division points out that the USPAP study which was conducted deviated in certain aspects from the procedures of a Section 482 Regulations study, the Division has not established how any of such deviations invalidated the 1996 Study or the result determined therefrom.

U. The goal, in arriving at a value and an indicated royalty rate via a study conducted pursuant to USPAP standards, is to emulate a fair market transaction. As set forth earlier, the essential question to be answered is whether the subject rates are those to which two unrelated parties otherwise resembling Talbots and Classics would have agreed in a hypothetical market transaction for a license to use the Talbots trademarks (***see, Matter of Sears, Roebuck & Co., supra.***). That is, could Classics command from, and would a potential licensee having all of the attributes and carrying on all of the business functions of Talbots save for the trademarks be willing to pay, royalties based on the respective rates of 1.8% and thereafter 6% of net sales in order to be able to affix the Talbots trademarks to their otherwise unbranded products, locations and services. Turning first to the 6% royalty rate determined as the result of the 1996 Study, the same was prepared in a manner consistent with the principles underlying the Section 482 Regulations. The 1996 Study was prepared by a competent valuation expert who applied the

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[16] While the dollar amounts of the royalty payments were not distortive, the lack of any business purpose or economic validity apart from tax avoidance underlying the structure pursuant to which such payments were made did, as concluded earlier, constitute distortion.

recognized standards of USPAP and who had an intimate familiarity with the history and evolution of Talbots as gleaned from two prior valuation engagements with Talbots.[17] Most of the activities performed were identical to those which would have been performed as part of a study pursuant to the Section 482 Regulations. A functional analysis of Talbots was performed, together with a review of relevant documents and market based research. Mr. Reilly is fully familiar with IRC § 482 and the Section 482 Regulations and has prepared numerous studies pursuant thereto, and he thoroughly explained the 1996 Study and that it was conducted in a manner consistent with the Section 482 Regulations. He explained, and Dr. Silva essentially agreed, that the RPSM was the most reliable method and would likely be the "best method" applied pursuant to the Section 482 Regulations. Mr. Reilly further explained why he utilized multiple methods of analysis to arrive at his point royalty rate estimate and his corroborative or supportive data. He stressed that the USPAP procedures are in fact more appropriate for the type of valuation engagement in which he was involved than are the Section 482 Regulations, noting that he was engaged to determine a then-current fair market royalty rate, as opposed to testing an already chosen rate after the fact as would be the case with conducting a study pursuant to the Section 482 Regulations. The Division did not challenge the validity or soundness of the USPAP standards themselves, nor provide any evidence that the same were incorrectly applied,

[17] The Division has pointed out that the work papers generated in connection with the 1988 Study and the 1993 Study were not available as of the time of the subject audit, having been destroyed in accordance with USPAP's records retention protocol (***see,*** Finding of Fact "39"). In this regard, the Division argues that provisions of the Tax Law and Regulations require a taxpayer's retention of its records for particular periods of time if they are, may be, or may become relevant to the determination of a taxpayer's tax liability (***see, e.g.,*** 20 NYCRR 39.1[1]; 20 NYCRR 158.8[a]; 20 NYCRR 533.2) . While the unavailability of Mr. Reilly's work papers for the earlier studies may have been a detriment to the Division in its ability to address the 1996 Study, it remains, as Talbots points out, that the record retention provisions of the Tax Law apply to the *taxpayer.* Further, unlike the 1996 Study, the earlier studies were not "tax studies" *per se*, but were valuation studies performed primarily for purposes of allocating the purchase price of Talbots from General Mills (1988), and determining the purchase price for the Talbots trademarks by Jusco BV (1993). Moreover, it is Talbots, and not Willamette or Mr. Reilly which is the *taxpayer* subject to the provisions of the Tax Law, and thus apart from USPAP protocols neither Mr. Reilly nor Willamette nor, by extension, Talbots should be penalized by reason of the absence of the work papers generated in the preparation of studies conducted many years prior to the time of the Division's audit for the period in issue.

nor any substantial evidence to show that the 6% royalty rate determined via the 1996 Study was incorrect or was not an arm's length rate. The Division did not, as noted, perform its own valuation study, either pursuant to IRC § 482 and the Section 482 Regulations, or USPAP, or otherwise.

V. ***Matter of Silver King Broadcasting of N.J., Inc. (supra.)***, involved a study made by an individual with a high level of particular knowledge, training and experience in the value of broadcast, cable and network entities and in the underlying types of assets and transactions being valued, but not conducted pursuant to the procedures of the Section 482 Regulations. Testimony showed that the same comported with the principles of IRC § 482 and the Section 482 Regulations, and was given credit as the basis for concluding that the intercompany pricing at issue in that case reflected arm's length pricing. The fundamental question is whether a given study and its results show, consistent with the principles underlying IRC § 482, that the price charged is that which an unrelated party would have paid for the same property or right involved in the controlled transaction. Here, the 1996 Study, led by an appraisal expert with some 30 plus years of experience, specifically in the valuation of intangibles, was performed in a manner consistent with such principles. The Division's expert witness, while fully familiar with the Section 482 Regulations, was admittedly not an expert in or qualified to offer expert testimony upon the USPAP standards. Nonetheless, he was familiar with the USPAP standards and acknowledged that the same could satisfy the Section 482 Regulation standards. He also admitted that the 1996 Study was conducted in a manner consistent with the methods and procedures set forth in Chapter 22 of the Handbook, entitled Transfer Pricing Case Study. Ultimately, Dr. Silva's conclusion regarding the 6% rate is telling, to wit, "[m]y conclusion is that I do not know what the six percent represents. It does not represent a number established pursuant to section 482." It is simply not enough for the Division, which did not perform a valuation study, to say, in the face of the study performed here, that the same was not a Section 482 Regulation study, that we do not know what rate is appropriate, including the selected rate, or that our assumptions and application would come to a different rate if we, or you, had performed a Section 482 Regulation study.

W. The strongest criticisms of the 1996 Study (apart from the generic criticism that it was not a study conducted pursuant to the Section 482 Regulations) concern the assertions that Classics did not appropriately compensate Talbots for the overwhelming amount of organizational and promotional services Talbots provided to Classics, and that Mr. Reilly's judgment and conclusion that 50% of Talbots excess profits were derived from the value of the Talbots trademarks was impermissibly imprecise (pursuant to the standards of the Section 482 Regulations). With regard to the former, the Division argues that given the level of support from Talbots it is unlikely that Classics could command a royalty rate of 6% from an unrelated licensee. With regard to the latter, the Division argues that Mr. Reilly failed to specifically identify or recognize other organizational or intangible assets possessed and employed by Talbots, and that more time and effort should have been devoted to individually valuing such other assets rather than simply concluding that the "other" 50% of Talbots excess profits was attributable to such other assets. Essentially, the Division takes issue with Mr. Reilly's conclusion that such a great deal of Talbots' excess value was derived from its only "unique" intangible asset, the Talbots trademarks, and that its clothing styles and quality, distribution system, stores, and other organizational assets, while valuable, were not unique but were similar to the same types of organizational assets possessed by Talbots competitors (or peer group). In ***Matter of The Sherwin-Williams Company (supra.)***, the Tribunal adopted the premise that an appraisal which essentially ignores a company's organizational assets will overvalue its trademarks. Analysis of the valuation report in ***Sherwin-Williams***, revealed that the same attributed some 76% of the total value of Sherwin-Williams' intangible assets to the trademarks, leaving only a "mere 24%" attributed to its "other intangible assets" such as "multiple distribution channels, ability to maintain quality control and the ability to adapt to a changing marketplace . . . ." In contrast, and unlike ***Sherwin-Williams***, the appraiser here did not ignore Talbots' organizational or other unidentified intangible assets, or conclude that nearly all of the excess profits were generated by or were attributable to the trademarks. Rather, he attributed a full 50% of the excess profits as having been derived from such "other intangible assets" (***see***, Finding of Fact "79"). This choice of allocation was made to capture and reflect both the existence of unidentified organizational intangible assets as well as any unrecorded appreciation in the value of Talbots' other (recorded) assets over time (i.e., from the time of the 1988 Study and its identification of assets and assignment of values thereto through 1996). Mr. Reilly recognized and readily agreed that such other assets, while not unique, were unquestionably valuable in the aggregate, and that these organizational (other unidentified intangible) assets in equal combination with the trademarks accounted for Talbots' outstanding performance and its robust excess profits, in general and in comparison to its peers. His opinion was based on all of the evidence gathered via the functional analysis of Talbots' operations and reflected his best professional judgment in light of the passage of time and the changes in Talbots' business and its success since the 1988 Study and the 1993 Study, including its continued growth and success, increased profitability, improved customer demographics and improved name recognition. The result of Mr. Reilly's 50% judgment was to assign two-thirds of the total profit as attributable to Talbots (i.e., one-third as return on capital and one-third as attributable to Talbots' "other intangible assets") with one-third attributable to the trademarks. Finally, the 50% judgment was one made with the conscious belief that the same might well be a conservative attribution of value to the trademarks and that this imparted, if anything, a downward bias into the royalty rate ultimately determined, especially in light of the clear and undisputed ongoing growth, profitability and strength of Talbots' business and, concomitantly, its name.

X. The overall record as well as the 1996 Study bear out that "success has bred success," with a resulting increase in value to the Talbots name. Mr. Larsen's presentation to Talbots' board of directors concerning the proposal to amend the 1993 License so as to increase the royalty rate was premised upon the 1996 Study and the conclusion, based thereon, that the royalty rates in the 1993 License, itself reflecting a carryover of rates established by (and at the time of) the 1988 License, were "below competitive rates in light of the importance of the tradename/trademark to the business and profitability" (***see***, Finding of Fact "30"). Clearly, this increase in value to the Talbots trademarks did not happen suddenly, but rather occurred over time, in connection with a number of the items identified in the 1996 Study, including the noted increase in the level of Talbots' labeled merchandise to nearly 100 percent, the positive changes in customer demographics, Talbots continued growth in general, and the like. Coupling this with the acceptance that Talbots has established the validity of the 6% royalty rate as of FY 1996 fully supports the conclusion that the operative royalty rate of 1.8% of net sales for the two preceding fiscal years (FY 1994 and 1995) was in fact below competitive (i.e., arm's length) rates for such years (or certainly would fall within [and in all likelihood fall below]) the range of arm's length rates for such fiscal years. The Division's criticisms do not readily show where this logic and conclusion is flawed, but rather lead to the generic criticism that "we just don't know if, and certainly doubt, the subject rates represent fair rates for any of the years." While Talbots bears the burden of proof in establishing the legitimacy of the intercompany pricing the Division cannot, by the various criticisms of the manner in which the 1996 Study was conducted or by identifying possible areas of distortion, place upon Talbots an insurmountable burden of proof or establish that the Division has shouldered its burden, notwithstanding the statutory presumption of distortion, of going forward to refute the validity or result of the 1996 Study (***see, Matter of Silver King Broadcasting of N.J., Inc., supra.***).

Y. The petition of The Talbots, Inc. is granted insofar as to reflect the pre-petition cancellation of the notices numbered L-020627001 and L-020627002 pursuant to BCMS Order (***see***, Finding of Fact "3"), and further insofar as to reflect that the tax, penalty and interest resulting from the proposed combination of Talbots and Talbots International has been eliminated (***see,*** Finding of Fact "5"), but is otherwise denied, and the notices of deficiency dated December 14, 2001, as remaining and as reduced in accordance herewith, are sustained.

DATED: Troy, New York
March 22, 2007

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE