STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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.

DECISION
DTA NO. 820168

Petitioner, The Talbots, Inc., and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on March 22, 2007. Petitioner appeared by Brann and Isaacson, Esqs. (Martin I. Eisenstein, Esq., and David Swetnam-Burland, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Nicholas A. Behuniak, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition to the Division of Taxation's exception and support of its exception. The Division of Taxation filed a reply brief and in opposition to petitioner's exception. Petitioner filed a reply brief. Oral argument, at the request of the parties, was held on March 10, 2008 in New York, New York.

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

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

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Procedural Background

1. 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] 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.

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

2. Talbots 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.

3. 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.

4. 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 that 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

5. 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.

6. 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.

7. 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 "17"). 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);

(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."

8. 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.

9. 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]

10. 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:
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> (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.
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> (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,

[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).

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.

11. 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

12. 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]

13. 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.

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.

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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.

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.

14. 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 that 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.

15. 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.

16. 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.

17. 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

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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.

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."

18. 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.
>
> 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.)

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.

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

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.

19. 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;

(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

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[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.

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.

20. 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.

21. 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;"

(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.

22. 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.

23. 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 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.

24. 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

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[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 "4"). 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.

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.”

25. 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

26. 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.

27. 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.

28. 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 "10").

29. 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 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

[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 that 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.

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

30. 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.

31. 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.

32. 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 "6"), 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.

33. 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.

34. 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 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

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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.

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 who 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.

35. 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.

36. 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

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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

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 that the royalty rate for the use of the Talbots trademarks should be 6% of net sales.

37. 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.

38. 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 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

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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 "91").

had, by the time of the subject audit, been destroyed and thus were not available to be provided to the Division.

39. 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.

40. 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.

41. 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.

42. 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%.

43. 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."

44. 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 to be extremely important and audits all of the manufacturers of its products. Talbots performs extensive quality control on all of the goods it has manufactured.

45. 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.

46. 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.

47. 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.

48. 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.

49. Talbots has a trained and assembled workforce.

50. 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.

51. 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.

52. 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.

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

54. 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.

55. 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.

56. 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.

57. 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.

58. 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.

59. Mr. Reilly also reviewed Talbots' "Vision 2000 Plan," a strategic plan for the company that was issued at roughly the same time that 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.

60. 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.

61. 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").

62. 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.

63. 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.

64. 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.

65. 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.

66. 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.

67. 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 "60"). 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.

68. 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

69. 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 that 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.

70. 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 "89" and "90").

71. 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.

72. 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.

73. 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 that 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.

74. 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.

75. 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; and

> (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.

76. 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.

77. 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.

78. 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%.

79. 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.

80. 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%.

81. The third primary method employed by Mr. Reilly was the approach known as the excess earnings method ("comparable profit margin" or "CPM" method). 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 Associates "Annual Statement

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

82. 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.

83. 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 "75 [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 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%.

84. 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 "59").

85. 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.

86. 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).

87. 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 that 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).

88. 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.

89. 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.

90. 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.

91. 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 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.

92. 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

judgment 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.

93. 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.

94. 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

95. 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.

96. 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.

97. 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.

98. 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.

99. 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 that 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 that 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.

100. 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 that no such CUTS could have been found.

101. 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.

102. 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 "85 through 90"), and stated his opinion that Mr. Reilly should have completely disregarded this market data.

103. 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 that 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

104. 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 "9"). 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.

105. 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 that 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.

106. 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.

107. 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.

108. 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.

109. 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.

110. 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.

111. 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 "10" and "28"). 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.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

At the outset, the Administrative Law Judge explained that the statute gives the Division the authority to require corporations subject to New York State corporation franchise tax to file combined reports with certain other corporations where three conditions are met, e.g., stock ownership test, unitary business test and a distortion of income test. The Administrative Law Judge noted that petitioner could rebut the presumption of distortion if it demonstrated that the intercompany transactions, here the royalty payments from Talbots to Classics, were based on arm's length royalty rates.

In addition, the Administrative Law Judge stated that even if the intercompany payments were at arm's length, there must still be a business purpose and economic substance to the intercompany arrangement. Citing our decision in ***Matter of The Sherwin-Williams Co.*** (Tax Appeals Tribunal, June 5, 2003, ***confirmed*** 12 AD3d 112 [2004], ***lv denied*** 4 NY3d 709 [2005]), an intercompany arrangement that has no economic substance or business purpose apart from tax avoidance will be disregarded.

The Administrative Law Judge concluded that based upon the record in this case, there was no economic substance or business purpose behind making Classics the owner of the trademarks. In fact, the Administrative Law Judge determined that the reasons set forth by

petitioner were "thin at best and leave no sense of any business or economic purpose of any real consequence" (Determination of the Administrative Law Judge, conclusion of law "N"). Thus, he upheld the Division's decision to require petitioner to file on a combined basis with Classics.

Although this conclusion necessarily disposed of the case, the Administrative Law Judge addressed the issue of whether the royalty payments were computed at arm's length rates and held that petitioner, in fact, did demonstrate the validity of its royalty rates.

ARGUMENTS ON EXCEPTION

In its exception, petitioner argues that the transaction through which Classics acquired the trademarks from Talbots for royalties paid was not a sham. Petitioner maintains that the decision to form Classics was not solely motivated to avoid tax and, in fact, it did not realize any tax savings. Therefore, it argues that the Administrative Law Judge erred in reaching his conclusion that there was no economic substance or business purpose for the transaction.

However, petitioner agrees with the Administrative Law Judge's determination that if we reverse the Administrative Law Judge on the dispositive issue, that its royalty rates were at arm's length and that it rebutted the presumption of distortion such that it would not be required to file its franchise tax returns on a combined basis with Classics.

In opposition, the Division asserts that the Administrative Law Judge properly found that the transaction at issue was a sham. The Division filed an exception to the alternative issue addressed by the Administrative Law Judge, which concluded that the royalty rates paid were at arm's length.

The Division explains that the expert report submitted in this case did not follow the guidelines set forth in the section 482 regulations. The Division states that it is not enough to do a report valuing the intangibles alone, but rather, it is necessary to conduct a transfer pricing analysis, which was not done in this case. Additionally, the Division takes issue with the lack of

supporting documentation provided to corroborate the results reached by Mr. Reilly. Although the Administrative Law Judge dismissed its concerns by pointing out that the original 1988 Study was several years ago and that he did not find it unusual for Mr. Reilly to no longer maintain the records that supported the Study, the Division strongly disagrees with this reasoning and states that if the documentation used for the 1988 Study were relied upon by Mr. Reilly for his later Study, it was incumbent upon him to maintain the records to substantiate his findings.

Therefore, the Division respectfully requests that the determination be upheld to the extent that the Administrative Law Judge found the transfer of the trademarks to Classics was a sham transaction but also that the Administrative Law Judge's conclusion with respect to the royalty rates between Talbots and Classics should be reversed and found not to be at arm's length rates.

OPINION

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]). Generally, 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).

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:

> [n]o combined report covering any corporation not a taxpayer shall be required unless the [Division] deems such a report necessary, because of inter-company transactions . . . in order to properly reflect the tax liability under this article . . . . (Tax Law § 211[4][a][4]).

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])."

As stated in the determination, Talbots owns all of the capital stock of Classics and petitioner and Classics are part of a unitary business. Thus, if there is a valid business purpose and economic substance to the intercompany transactions, the royalties rates charged here would indicate a presumption of distortion such that combined reporting may be required. 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).

Before addressing whether petitioner has sufficiently rebutted the presumption of distortion, we must analyze whether Talbots' license agreement with Classics lacked economic substance such that Classics was formed strictly for tax avoidance purposes. For if the arrangement that transferred the trademarks to Classics has no economic substance or business purpose apart from tax avoidance, the transaction will be disregarded (***Matter of The Sherwin-Williams Co.***, ***supra***). "The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction: while the economic substance inquiry "requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits" (***Rice's Toyota World v. Commissioner***, 752 F2d 89 [1985]).

Despite petitioner's argument to the contrary, it is necessary to begin our analysis by looking at the original transfer of the trademarks to Jusco BV, which was a Dutch holding company. As set forth in the facts above, on June 26, 1988, Jusco BV and Talbots executed the 1988 License by which Talbots obtained the right to use the Talbots worldwide trademarks in exchange for certain royalty payments. Furthermore, the facts outline the specifics of the License. Talbots was in charge of every aspect of maintaining and using the trademarks, including setting the quality standards and developing the Marketing Plan. Jusco BV had two part-time employees, did not own any property, real estate or office space and it was not involved in any of the operations of Talbots whatsoever. This scenario surrounding the trademarks remained the same even after Classics acquired the trademarks from Jusco BV.

As pointed out by the Division in its brief in opposition and reply (see, pp. 8-9), Classics never performed any quality control work with regard to the trademarks; never performed any

product research or development; and never performed any product manufacturing or distribution. Classics did not perform any store development nor any catalog creation or mailings, did not sell any branded products or pay any advertising expenses. In fact, Classics did not have any employees who did not work for Talbots, and such individuals worked on a part-time basis. The only party that employed the trademarks in this case was Talbots. Talbots role with respect to the trademarks was the same, beginning in 1988 when the trademarks were first stripped from petitioner up through the acquisition of the trademarks by Classics.

In ***Matter of The Sherwin-Williams Co. (supra)***, we discussed the role of trademarks to a company.

> From an economic perspective, trademarks play a role in the process of product differentiation, a process that assists a company in distinguishing its products from those of competitors in an effort to generate a profit level that exceeds the average profit for companies engaged in the same business. The role that a trademark performs in this regard is to convert the product into a branded product.
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> * * *
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> [A] trademark, standing alone, has no intrinsic value. Its value is based upon its recognition of representing the quality and services associated with products bearing the trademark. These attributes are supplied by the trademark owner's other intangible assets such as its organization capital, which includes marketing and advertising capabilities.

In poring over the voluminous record in this case and focusing on all of the relevant facts, it is clear that placement of the trademarks was a well thought out and aggressive tax avoidance scheme that was accomplished over a number of years. Although petitioner attempts to distinguish its case from ***Sherwin-Williams***, we find such case directly on point. As borne out by the complete lack of evidence indicating any purpose whatsoever outside of a tax savings motivation for Classics purchasing the trademarks, we find that the transaction between Talbots and Classics lacked any economic substance or any valid business purpose. Therefore, we find

that the Division properly required petitioner to file on a combined basis with Classics during the years in issue.

Although the Administrative Law Judge, noting that his primary conclusion rendered the transfer pricing issue moot, dealt with the issue of whether the royalty rates charged were at arm's length, we decline to do so in this decision. As set forth by the Third Department in ***Sherwin-Williams***, "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 The Sherwin-Williams Co. v. Tax Appeals Tribunal, supra***, at 118).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Talbots, Inc. is denied;

2. The exception of the Division of Taxation is rendered moot;

3. The determination of the Administrative Law Judge is sustained consistent with our decision herein;

4. The petition of Talbots, Inc. is granted to the extent set forth in the conciliation order and further as to reflect that the tax, penalty and interest resulting from the proposed combination of Talbots and Talbots International has been eliminated, but is otherwise denied; and

5. The Notices of Deficiency dated December 14, 2001, as modified in accordance with paragraph "4" above, are sustained.

DATED: Troy, New York
September 8, 2008

/s/ Charles H. Nesbitt
Charles H. Nesbitt
President

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

/s/ Robert J. McDermott
Robert J. McDermott
Commissioner