STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
KELLWOOD COMPANY	:	
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended January 31, 2000 through January 31, 2003.	:	DETERMINATION DTA NO. 820915

Petitioner Kellwood Company filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended January 31, 2000 through January 31, 2003.

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on March 19, 2007 through March 23, 2007, with all briefs submitted by September 27, 2007, which date began the six-month period for the issuance of this determination. Petitioner appeared by Jane Wells May, Esq., Catherine Battin, Esq., and John A. Biek, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Jennifer L. Baldwin, Esq. and Clifford M. Peterson, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation may properly require petitioner, Kellwood Company, to file its New York State Corporation Franchise Tax Report on a combined basis with its wholly-owned nontaxpayer subsidiaries Kellwood Financial Resources, Inc., and Kellwood

Shared Services, Inc., because petitioner has failed to rebut the presumption of distortion under section 6-2.3 of the Division's regulations (20 NYCRR 6-2.3).

II. Whether petitioner has established reasonable cause and that it acted in good faith for the abatement of penalty asserted by the Division of Taxation pursuant to Tax Law § 1085(k).

FINDINGS OF FACT

Introduction

1. Petitioner, Kellwood Company (Kellwood), is a Delaware corporation with its principal place of business located in Chesterfield, Missouri.

2. Through several operating divisions and subsidiaries, Kellwood is a supplier of moderately priced fashion apparel and recreational products under a variety of brand names to retail stores and other businesses. Kellwood's core products are women's sportswear, men's sportswear, children's apparel, newborn and infant apparel, intimate apparel, and camping and recreational products.

3. Kellwood Financial Resources, Inc. (KFR) and Kellwood Shared Services, Inc (KSS) are wholly-owned subsidiaries of Kellwood.

4. Kellwood is subject to corporation franchise tax under Article 9-A of the Tax Law.

5. Kellwood timely filed New York general business corporation franchise tax reports on a separate company basis for each of the fiscal years at issue and paid the tax computed to be due.

6. During the audit period, Kellwood, KFR, and KSS were engaged in a "unitary business" and had "substantial intercorporate transactions" as those terms are defined under Article 9-A and the regulations promulgated thereunder.

7. It is the position of the Division of Taxation (Division) that Kellwood's separately filed reports distort its New York income and that, as a result, combined returns with KFR and KSS are necessary to properly reflect Kellwood's income.

8. It is Kellwood's position that its filed franchise tax reports for the audit period properly reflect its liability.

The Audit

9. The Division audited Kellwood's filed franchise tax reports for the fiscal years at issue.

10. During the course of the audit, the Division made numerous information and document requests. Kellwood's responses to the Division's requests were made part of the Division's audit file.

11. By letters dated September 29, 2004 and December 10, 2004, the Division requested the following:

> (1) Provide copies of any and all internal correspondence or documentation within [Kellwood] that discussed the creation or establishment of Financial and/or Shared Services before, during, and after said creation or establishment. . . .
>
> (2) Provide copies of any and all external correspondence or documentation between [Kellwood] and any third party discussing the creation or establishment of Financial and/or Shared Services before, during, and after said creation or establishment . . .

12. By the same letters, the Division also requested "copies of any correspondence, documents, work papers, and other materials used or generated by Ernst and Young" for petitioner's 2001 and 2003 reports (***see*** Findings of Fact 123 and 127).

13. By letter dated December 14, 2004, Kellwood responded to the Division's request for external correspondence or documentation relating to the creation of KFR and KSS with the following:

> Enclosed are five binders of information provided by Ernst & Young at the time both Financial and Shared Services were created. Some of the information has been sent to you previously. The information is in the same format as provided to Kellwood by Ernst & Young.

14. For purposes of computing the combined receipts factors, the auditor used $62,858,147.00, $56,785,500.00 and $46,324,497.00 as KFR's receipts for the fiscal years ended January 31, 2002, January 21, 2002 and January 31, 2003, respectively. Kellwood reported these amounts on its federal tax returns (Forms 1120). The auditor also eliminated $37,714,888.00 for the fiscal year ended January 31, 2001 and $37,152,714.00 for the fiscal year ended January 31, 2002 from Kellwood's combined receipts factors, which represent KFR's intercompany receipts with Kellwood.

15. KFR's taxable income represents between 40.88 percent and 74.84 percent of the Kellwood Consolidated Group's taxable income for the following years:

Kellwood Company Consolidated Group
Federal Form 1120 Taxable Income

	FYE 1-31-03	*FYE 1-31-02*	*FYE 1-31-01*
Consolidated Group	$62,887,791	$122,417,710	$71,119,276
KFR	$46,489,608	$50,048,190	$53,226,748
KFR Income as % of Consolidated Group	73.91%	40.88%	74.84%

16. As a result of the audit the Division issued to Kellwood a Notice of Deficiency, dated October 11, 2005, which asserted total additional tax due of $1,620,646.00, plus interest of $425,372.20 and penalty of $162,061.00, for the fiscal years ended January 31, 2000 through January 31, 2003. Additional tax due in the notice includes both corporation franchise tax under Article 9-A and the Metropolitan Commuter Transportation District tax surcharge. Penalty is asserted pursuant to Tax Law § 1085(k) for a substantial understatement of liability.

17. The Division's computation of additional tax due and the subsequent issuance of the Notice of Deficiency were premised on the Division's position that Kellwood was required to file combined reports that included KFR and KSS for each fiscal year in the audit period.

History of Kellwood

18. Sears Roebuck and Company (Sears) formed Kellwood in 1961 by combining 15 of Sears' independent suppliers. Sears owned approximately 20 percent of Kellwood and had a representative on Kellwood's board of directors.

19. Kellwood's business at that time consisted of manufacturing men's, women's and children's apparel for Sears under its private label. Kellwood also had a recreational products division and a home fashions division.

20. During this early period, Kellwood essentially operated as a holding company, and there was little centralization of business operations among its individual business units, with the exception of its legal, treasury, accounting, tax, and audit functions. The individual business units retained their autonomy, essentially running their business operations in the same manner as before they were combined to form Kellwood.

21. The process of manufacturing clothes for Sears entailed agreeing on a design with Sears, purchasing the raw materials (which included fabric, zippers and buttons), producing the product, warehousing the product and distributing the product to Sears.

22. Kellwood sold over 90 percent of its products to Sears until the mid-1980s. Sears paid Kellwood its cost of production plus six percent. Sears also guaranteed Kellwood's accounts receivable and inventory with financial institutions, which insured a good financial rating for Kellwood. Kellwood was a highly leveraged company with a debt to equity ratio of one to one.

23. The cost of production plus six percent arrangement between Kellwood and Sears was favorable for Kellwood because Sears dominated the apparel industry at that time. Kellwood's plants were fully utilized and Kellwood prospered. In the early 1980s, however, Sears' business started to decline and Kellwood's business declined dramatically. As a result, Kellwood had to close a number of its manufacturing plants and was in poor financial health.

24. When Sears began to lose market share in the mid-1980s, Kellwood made a number of efforts to increase its profitability including moving toward manufacturing products with higher margins and expanding its customer base.

25. Kellwood broadened its operations beyond private label products for Sears to market-driven labels that had higher margins and profitability. Market-driven labels are those labels or brand names that consumers recognize.

26. Kellwood initially had difficulty expanding its customer base. Competitors of Sears were hesitant to become customers of Kellwood because of Sears' 20 percent ownership interest and its resulting access to Kellwood's financial data.

27. Kellwood ultimately purchased Sears' 20 percent interest in the mid-1980s. The loss of Sears as an owner resulted in a loss of the Sears guarantee of Kellwood's accounts receivable and inventory, which weakened Kellwood's financial status.

28. Kellwood acquired approximately 20 companies from 1985 to the early 2000s as part of its strategy to broaden its customer base. By the early 1990s, Kellwood's customer base had already become diversified, with sales to its largest customer accounting for only about 12 to 13 percent of Kellwood's total sales. Kellwood's customers included department stores (such as Federated and Macy's), chain stores (such as Gap and Hilfiger's), and discounters (such as Target, Wal-Mart and Kmart).

29. The acquisitions did not change Kellwood's decentralized business structure. Similar to the original Sears supplier companies that were merged to form Kellwood, the newly acquired companies were run by their former owners. These individual "business units" handled virtually all business functions with the exception of the few functions performed by Kellwood corporate.

30. Kellwood organized the company into three separate groups: men's, women's and "other," each of which was headed by its own president. Despite the existence of the group presidents, the business units continued to make their own business decisions and act autonomously. The business units often sold products to the same customers and thus functioned as competitors.

31. During the period 1985 to 2000, Kellwood faced two principal types of business risks: inventory risk and credit and collection risk. The inventory risks were associated with Kellwood's production of a significant amount of private label products, which could only be sold to a specific customer. Thus, if a particular customer had a problem (e.g., fell out of favor or was subject to a Kellwood-imposed credit hold), Kellwood would have significant problems selling that inventory already in the pipeline. The credit and collection risks related to the risks of noncollectibility, delayed collectibility, and partial collectibility of accounts receivable. Partial collectibility refers to the tendency of customers in the apparel industry to charge suppliers for any deviation from compliance with the customer's policies or instructions, a practice known as charge-backs.

32. For private label transactions, Kellwood extended credit to its customers from the time it purchased raw materials, since private label products can only be sold to a specific customer. In non-private label transactions, credit is not extended to the customer until the goods are shipped.

33. Each of Kellwood's business units handled its own credit and collection function, either through its own credit department or through an independent factoring company.

34. During 1985 to 1998, the personnel of the individual business units independently decided how much credit to extend to a particular customer. Each individual business unit also independently determined the payment terms with the customers, which were typically anywhere from 60 to 90 days. As a result of these independent decisions, prior to 1998, the payment terms varied from business unit to business unit. The individual business units invoiced their customers and collected the accounts receivable.

35. Kellwood management made efforts to try to gain information about credit and collections from each business unit. Such efforts were not successful because of a lack of common systems among the business units and Kellwood's historically autonomous culture and organization. Kellwood management encouraged the business units to have strong credit and collection departments, but did not have the tools necessary to do anything other than consult with the business units and give them broad guidelines.

36. Despite having some of the same customers, the individual business units did not coordinate to determine how much total credit to extend to a customer. Given Kellwood's historically autonomous culture and organization, Kellwood management did not exercise control over how much credit was extended to a particular customer. The individual business units made the final decisions.

37. By the late 1990s, Kellwood management believed that its decentralized structure had a negative impact on its profit margins because of the inefficiencies within Kellwood and the inability to implement best practices. Kellwood management was unable to get accurate, timely

information from the business units about credit and collections and did not, in all cases, have a professional staff in place at the business unit level.

38. Some of the companies that Kellwood acquired retained their agreements with factoring companies. Since the owners of the businesses generally continued to run them after they were acquired, the prior owners decided whether to retain the factoring agreement or to build their own credit staff. Kellwood benefitted by the decision to leave the factoring agreement in place in at least one instance, because Kellwood's factor bore the expense for Montgomery Ward's uncollectible receivables.

Factoring

39. Factoring companies buy accounts receivable at a discount from retailers either with recourse or without recourse. If accounts receivable are purchased without recourse, the factor assumes the complete collection responsibility and risk. If the accounts receivable are purchased with recourse and the factor is unable to collect the receivables, the factor has the right to send the receivables back to its client.

40. Factors often advance some percentage, typically 70 to 90 percent, of the face value of the accounts receivable. A factoring arrangement allows a company to accelerate its cash flow by converting accounts receivable into cash and also provides a company with a professional, organized credit function.

41. Factoring is very prevalent in the apparel industry. Companies enter into factoring agreements to outsource their credit and collections functions. Selling accounts receivable to a factor reduces head count and administrative responsibilities and allows the apparel companies to focus on their core business.

42. Under a factoring agreement, a factor typically receives a commission for bearing the bad debt risk and managing the receivable. The commission is expressed as a percentage of the receivables that are factored. In consideration for the commission charge, the factor analyzes the creditworthiness of the customers, approves credit limits, manages and tracks the accounts receivable, and handles collection issues that arise. The commission charge also reflects the assumption of the risk relating to the receivables, and therefore, factors receive greater compensation for factoring riskier receivables.

43. In addition to the commission, miscellaneous fees are also charged for the factoring function. For example, factors commonly charge additional amounts if the accounts receivable terms of sale are longer than 60 days. Factors also charge fees for late payments, audits, legal fees associated with collection, and setting up new customer accounts.

44. Factors are also compensated for the funds the factor advances the company in exchange for the accounts receivable, which is usually referred to as an interest charge. Such advances usually account for the largest part of the consideration paid to a factor. While not a loan, this is a form of financing as it provides the company with access to working capital. Along with outsourcing of credit and collections, the short term financing through factoring is a primary reason why companies factor. As noted, factors typically advance 70 to 90 percent of the total receivables. The interest charge tends to be tied to market interest rates, generally to the prime rate. The cost of financing through a factoring agreement is generally higher than other sources of financing, including a revolving credit facility.

45. In a typical factoring agreement, the commission charge, the miscellaneous charges and the interest charge on the advance are separately stated.

Economic Climate in the Apparel Industry

46. The economic climate in the apparel industry was difficult in the late 1980s and 1990s. There were a number of retailer bankruptcies during this period which resulted in uncollectible accounts receivable, pipeline inventory that could only be sold to discounters, and a general weakening of the industry from a credit standpoint.

47. The apparel industry also suffered during the late 1980s and 1990s from the growth of discounters such as Wal-Mart. The unusual combination of fewer customers, because of bankruptcies, and more stores, because of the growth of discounters, put continuing pressure on the margins of wholesalers and manufacturers.

48. The apparel industry was also impacted by the outsourcing of manufacturing to Asia, which drove the cost of goods down in an already competitive industry.

49. Some apparel manufacturers went bankrupt during the late 1980s and 1990s; others were sold or consolidated because they were facing difficult times.

50. These industry changes greatly impacted Kellwood. During this time period, Kellwood’s prices decreased due to consolidation in the industry. Kellwood’s margins were tighter because it was forced to sell at a lower operating margin to big discount retailers such as Wal-Mart. Kellwood’s operating margins during the late 1990s and 2000s were similar to those of a low third or fourth quartile (i.e., poorly performing) company.

51. During the late 1990s and early 2000s, Kellwood’s credit rating was weak because it had so much inventory. The reduced credit rating impacted the interest rate that Kellwood had to pay financial institutions and it limited the amount of money banks were willing to lend.

52. Kellwood was turned down for a credit increase in the early 2000s. As a highly leveraged company, Kellwood had to continuously search for financing.

53. During the early 2000s, Kellwood was considered to be a weaker company in the very competitive apparel industry. In March of 2002, Moody's downgraded the ratings of Kellwood based on its decline in sales and earnings resulting from a difficult operating environment and changes in the market position and strategy of Kellwood's customers. The downgrade also reflected Moody's acknowledgment of the risks that Kellwood's performance would be more volatile going forward because of industry bankruptcies and an overall weakening of the credit environment for apparel companies.

54. During the early 2000s, the credit ratings of a number of Kellwood's customers were also downgraded, which also negatively impacted Kellwood's credit rating. Kellwood also suffered losses when several of its customers, including Montgomery Ward, Kmart and Ames Department Stores, filed for bankruptcy because accounts receivable were difficult to collect and inventory had to be sold at distressed prices. For example, when Ames Department Stores filed for bankruptcy, Kellwood had roughly one and a half million dollars worth of uncollectible receivables and an almost equal amount of inventory in the pipeline that it was forced to sell at distressed prices.

55. A Moody's Investor Services Report dated July 2002 described a number of challenges facing the apparel industry including the dominance of retailers over distributors and increasingly concentrated distribution. Apparel companies also faced the increasing demand for private label products, which could only be sold to specific stores.

Centralization of Kellwood's Credit and Collection Function

56. At hearing former Kellwood executive Lawrence E. Hummel[1] testified that in the late 1990s Kellwood had approximately $400 million in accounts receivable, net of reserves, at any one point in time. Kellwood measured the length of time it took to collect its accounts receivable by looking at DSOs ("days sales outstanding"). DSO is a measure of how effectively Kellwood was utilizing its working capital and cash flow; DSO also impacted Kellwood's debt and interest expense.

57. While Kellwood management desired to lower its DSOs, this goal was not a top priority for the business units. Kellwood management lacked the real-time information relating to the amount of receivables, collections, shipments and inventory in the pipeline because of a lack of common operating systems and was, therefore, unable to effectively impact DSOs. Each of the companies that Kellwood acquired had its own operating system.

58. Kellwood corporate typically received information from the business units about a month's data two or two and a half weeks after the end of the month. In several circumstances, this delay in receiving the information resulted in some business units extending credit to customers that were already in bankruptcy. On a regular basis, one business unit would extend credit to a customer that was behind on its payments to another business unit. This situation created an increased level of competition between the business units that was further heightened

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[1] Mr. Hummel retired from Kellwood in January 2006 as the Director of Finance. He held various positions during his 26 years with Kellwood, including Director of Internal Audit, Controller and Chief Accounting Officer, and Vice President Controller. In 1999 Mr. Hummel held the position of Vice President Controller at Kellwood. His responsibilities included internal and external reporting, SEC reporting, and internal, GAAP, and Kellwood policy compliance. Mr. Hummel's familiarity with Kellwood's business operations is based in large part on his experiences as Director of Internal Audit and Controller. Mr. Hummel was Vice President and an officer of both KFR and KSS. Mr. Hummel testified that he used the information and reviewed the actions of KFR and KSS but was not involved in either KFR's or KSS's day-to-day activities.

when one business unit placed a customer on hold and another business unit continued to ship to the same customer; the customer would then attempt to use the shipment by one business unit as a reason for the other business unit to resume shipment.

59. If Kellwood corporate had information that a customer was a credit risk, Kellwood would alert the business units and recommend that they try to expedite collection of their debt and hold their individual credit limits down. While the business units were encouraged to follow the directives from Kellwood corporate, there were instances where the directives or guidelines were not followed. If the business units overrode the credit guidelines, they were required to take the full responsibility for the write-off if the account receivable was not collected.

60. In 1996, Kellwood's CEO, Hal Upbin, formulated a strategy named "Vision 2000," which called for the centralization of Kellwood's "behind the curtain" functions, including the credit and collection function. The goal of the centralization was to achieve a significant reduction of costs and to make the back office functions more efficient and effective. Benchmarking studies had indicated that Kellwood was either in the third or fourth quartile for the cost of performing "behind the curtain" functions.

61. The goal of Vision 2000 was to create a financial shared services center where a number of the "behind the curtain" activities would be consolidated. The shared services center would, among other things, allow Kellwood to operate its credit and collection function in a consolidated manner, with credit approval to be done on a company-wide basis rather than at the individual business unit level.

62. As part of the Vision 2000 plan, the individual business units were to migrate into being serviced by the shared services center gradually, allowing time to train personnel.

Jerry Betro, a credit manager with one of the business units, was chosen as the corporate credit manager of the shared services center.

63. As part of Vision 2000, Kellwood's senior financial management made a presentation to the financial leaders of Kellwood on October 23, 1998, embodied in a document entitled, "Kellwood Company Vision 2000 Financial Process Improvement." According to the document, a "Financial Shared Services Center in St. Louis" would be responsible for credit, collections, and cash applications activities, and "chargeback/deduction management" responsibility would remain with the divisions. The goals of Vision 2000 as they pertained to Kellwood's "behind the curtain" functions included forming a financial shared services center to consolidate certain "behind the curtain" functions, streamlining certain financial processes, reducing costs through economies of scale, and implementing a customer service and team oriented environment. According to the "Kellwood Company Vision 2000 Financial Process Improvement" document, the centralization of Kellwood's credit and collections functions would involve the development of customer rating policies and procedures and approval of credit on a consolidated basis, monitoring of customer payment histories, maintaining information on the financial condition of its customers, improvement of customer relations with respect to payments, and coordinating "follow-up" and a "workout" program for those customers making late payments.

64. The "Kellwood Company Vision 2000 Financial Process Improvement" document set as a goal the replacement of the then-current 32 employees in credit and collections activities and 15 in cash applications at the divisional level with 15 employees in a consolidated shared services or credit and collections department.

65. The "Kellwood Company Vision 2000 Financial Process Improvement" document also stated that the creation of the shared services department would "eliminate factor fees."

66. Kellwood employed Price Waterhouse to assist in the implementation of Vision 2000. Price Waterhouse prepared a report, entitled "Kellwood Company Financial Shared Services Business Case" and dated "October 23, [1998]" which provided the written business case for creating a shared services division. Specifically, the report memorialized the problems that Kellwood was encountering with its present system, such as increased costs, inconsistent financial processes across the business units and a lack of best practices. According to the Price Waterhouse report, Kellwood anticipated saving $1,262,000.00 each year in 1999, 2000, and 2001 from the centralization of the credit and collections functions of Kellwood and its subsidiaries in a shared services division.

67. Kellwood implemented the Shared Services Division in accordance with the Vision 2000 plan. As a result of the Shared Services Division Kellwood became able to evaluate credit situations on a consolidated and real-time basis, obtain accurate information on a daily basis, and use that information to determine the proper course of action.

68. The managers of the shared services center implemented a system of monitoring and alerting the Business Units regarding two categories of riskier accounts called "risk" accounts and "monitor" accounts. Customers that were having financial difficulties (such as Kmart and Ames) were designated as "risk" accounts. Customers that had undergone a single credit downgrade or had slowed in making payments were designated as "monitor" accounts. Over time, the Shared Services Division serviced virtually all of Kellwood's receivables.

69. The shared services center was located in its own office space in Saint Louis County, Missouri. Fourteen employees of Kellwood's Sportswear Division Accounts Receivable Claims Department (the "Sportswear Division Employees"), who were located in Rutherford, Tennessee, assisted with the credit and collection functions.

Pursuit of Securitization as an Alternative Financing Vehicle

70. Kellwood traditionally raised capital through revolving letters of credit. In the 1990s, as part of its continuous search for financing in an increasingly difficult economic climate, Kellwood management discussed an alternative financing tool - securitizing its accounts receivable. Kellwood received presentations from financial institutions describing various ways to raise additional funds through participation in an asset-backed securitization transaction. Specifically, Banc One Company made a presentation, memorialized in a document entitled "Fundamentals of Securitization" and dated September 28, 2000. Later, Scotia Capital made a presentation, memorialized in a document entitled "Kellwood Company Industry Funding Corporation" and dated December 2002, which described asset securitization financing.

71. In 1999, Kellwood was not able to enter into a securitization transaction under its then-current structure because, although they were serviced by the Shared Services Division, the accounts receivable were still owned by a variety of legal entities (Kellwood and its subsidiaries) and a securitization transaction would require that they be owned by a single, bankruptcy-remote entity, referred to as a special purpose entity (SPE).

72. Kellwood began negotiations with its banks for a carve-out provision in its 1999 revolving credit loan that would enable it to enter into a $75 million asset-backed securitization transaction. This carve-out provision would allow Kellwood to gain additional financing on a short-term basis over and above the amounts loaned through the revolving credit agreement.

73. The banks were reticent to agree to the carve-out provision because it weakened their own credit situation by carving out more than $75 million worth of receivables from their asset group to give to another lender. However, Kellwood management believed that the carve-out provision was necessary, because Kellwood was continually bumping up against its credit

lines, the apparel industry was facing a downturn, and Kellwood was concerned about its ability to secure enough credit in the future.

74. Kellwood successfully negotiated the $75 million carve-out provision which was memorialized in Kellwood's credit agreement dated August 31, 1999.

The Factoring Strategy

75. Sometime in 1999 Kellwood, through its then-chief financial officer, Gerald Chaney, sought out Ernst & Young LLP (E&Y) to advise Kellwood on multistate tax planning ideas and strategies. E&Y interviewed employees of Kellwood on August 3 and 4, 1999. Additional meetings took place on August 24 and 31, 1999. E&Y presented its "SALT [State and Local Tax] Value Analysis" ideas to Kellwood on September 7, 1999. E&Y's tax savings ideas included an intercompany charge based on asset allocations, a trademark holding company and the formation of a factoring company. With respect to two of the three ideas, Mr. Hummel testified at hearing that it was his decision and that he turned them down because "They did not fit our business model. And, quite frankly, they had no purpose other than tax reduction. Businesses make decisions based on business considerations. At least Kellwood does." Kellwood elected to proceed with forming a factoring company because, according to Mr. Hummel, it made business sense. E&Y's proposal estimated annual tax benefits from the factoring company at $900,000 to $1,3000,000. Kellwood agreed to E&Y's proposal of a factoring company on October 6, 1999.

76. To implement the factoring strategy, E&Y proposed the following transaction:

> Kellwood would create a new legal entity for the purpose of acquiring the accounts receivable generated by the operating company. The acquisition of the accounts receivable would be at less than face value, thereby creating a deduction at the operating company level.

77. E&Y described the "tax strategy" of the transaction as follows:

> Because of the discounted purchase price, the operating companies will realize a loss on the sale of the receivables, and the factoring company will realize a gain, thereby shifting income out of the higher effective rate entities.

78. As noted, Kellwood accepted E&Y's proposal and engaged E&Y to assist in the organization, establishment, and implementation of what E&Y called the Factoring Strategy.

79. As part of the Factoring Strategy, E&Y delivered to Kellwood six binders of documents, including memoranda, informational templates, legal documents, and calculations, along with a detailed work plan that listed every step accomplished during the execution of the Factoring Strategy.

80. E&Y included in the binders an "Executive Summary of Restructuring," dated December 31, 1999, which "summarize[d] the evaluation, in-depth analysis, and implementation of a factoring company, Kellwood Financial Resources [KFR], and the transfer of Kellwood's shared services department to a wholly-owned subsidiary, Kellwood Shared Services [KSS]. According to E&Y, implementation of the Factoring Strategy required the following steps:

> (1) Effective January 1, 2000, [Kellwood] will form a wholly-owned Tennessee subsidiary, KFR which will be headquartered in Rutherford, Tennessee. The new subsidiary will operate as a factoring company and will purchase, with all the rights and obligations of ownership including the obligation to collect the monthly payments and bear the expenses in connection with their collection, accounts receivable generated from the operations of the selling corporations. KFR will buy the receivables on a non-recourse basis with respect to bad debts. Prior to KFR's formation, Kellwood will purchase $48,075,581.87 of trade receivables from [the Factoring Subsidiaries]. [Kellwood] will then contribute these purchased receivables and the receivables of [Kellwood's] participating operational division to KFR. [Kellwood's] total contribution will be $273,069,944.95 of the selling corporations' total outstanding trade accounts receivable and miscellaneous assets in exchange for 100% of KFR's stock.
>
> (2) [Kellwood] and all subsidiaries had a previous fiscal year end of 4/30/99. [Kellwood] is changing its fiscal year end to 1/31/00, and will operate on a

52-53 week basis. Although the contribution will be made on 1/1/2000, KFR will not begin operating until 2/1/2000.

(3) [Kellwood] will transfer fourteen (14) employees associated with [Kellwood's] Sportswear accounts receivable claims department to KFR on 1/31/2000 in order to avoid any payroll related compliance complications. Since KFR will not begin purchasing the receivables until February, KFR will lease its newly transferred employees to [Kellwood's] Sportswear division for them to continue performing accounts receivable claim functions for Sportswear during the month of January. Thereafter, these transferred employees will work for KFR and will be considered common law employees; however, to the extent these employees perform services for Sportswear, KFR will charge [Kellwood] an arm's length fee for those services. [Kellwood] will also assign all necessary Sportswear leases to KFR.

(4) One month after the contribution, KFR will purchase all the receivables generated by the selling corporations during the month of January. Afterwards, KFR will purchase, on a weekly basis, the receivables generated from the selling corporations' previous week's sales. These accounts receivable will be purchased at an arm's length discount value as determined by E&Y and as detailed in the Receivables Purchase and Sale Agreement. This discount rate will be applied on net receivables, and will not be adjusted based on the ultimate collection of the receivables (net receivables = gross receivables less charge back reserve, trade discounts reserve, over-billing reserves and return reserves). This discount rate will be based upon (1) time value of money, (2) bad debt exposure, (3) collection expense, and (4) fixed fee/profit amount. As mentioned in the valuation report, this discount rate should be updated annually, and at least every three years by an independent valuation expert.

(5) Effective January 1, 2000, [Kellwood] will form a wholly-owned subsidiary, KSS. KSS will be organized in Delaware and commercially domiciled in Missouri. [Kellwood] will transfer all the assets associated with [the Shared Services Division] in exchange for 100% of KSS's stock. [Kellwood] will transfer to KSS all the employees of [the Shared Services Division] and will assign all leases with [the Shared Services Division] to KSS.

(6) Acting as an independent contractor, KSS will perform credit analysis, provide credit approvals, collect cash from customers, distribute cash to and provide administrative support for the accounts receivable system (e.g. changes to customer master headers and update terms table) for DDDG, Sportswear, Lingerie and CLC. Beginning 2/1/00, this function will also include Koret [a Kellwood subsidiary] and its subsidiaries. Eventually, management anticipates a majority of [Kellwood's] business units will contract with KSS for the management of their credit and collection functions. KSS

also performs accounts payable and payroll functions for all business units. KSS will charge all business units an arm's length charge, as determined by E&Y, for these administrative services.

(7) KFR will contract with KSS to service and collect its receivables. KFR will pay KSS a servicing fee in an arm's length transaction, as outlined in the Receivables Collection and Administrative Service Agreement.

(8) Certain [Kellwood] business units will continue to collect payments related to their accounts receivable and will reconcile receivable balances for a short period of time. [Kellwood] has identified business reasons for this decision, including the complexity of changing payment methods by its clients, and the likely delay of payment by the clients upon adjustment of payment terms. Therefore, the collection of such payments on KFR's behalf and remittance to KFR will be included in the administrative services agreements between KSS, KFR and these business units.

(9) KFR will initially have fourteen (14) employees in its Tennessee corporate office who will manage the business affairs of KFR. These employees will be responsible for the following: calculating the purchased receivables; calculating the discount fee; establishing appropriate reserves for bad debts; year-end reporting; tax information gathering and all administrative functions of a factoring company.

(10) On a weekly basis, the selling corporations will submit the appropriate information to KFR in order for KFR to calculate and input the proper entries into the system as discussed in the Accounting Manual.

(11) [Kellwood's] current financial and management reporting system will not be affected except the adjustments discussed in the Accounting Manual. All accounting entries will be made on the appropriate adjustment division books in order to maintain the integrity of management reports.

Note: The Accounting Manual is an integral part of this project and should be reviewed independently of this executive summary in order to fully comprehend the accounting for this Factoring Strategy.

(12) KFR will file a separate company tax return in Tennessee and Massachusetts.

(13) KSS will file a separate company tax return in Missouri.

(14) Immediately upon formation and thereafter, KFR and KSS will join in the filing of a consolidated federal income tax return with [Kellwood] and its other consolidated group members.

81. Tax savings, according to E&Y, resulted from the following:

> Savings of multistate income taxes are achieved upon KFR's purchase of receivables from the selling corporations. KFR will be established in Tennessee due to the significant accounts receivable function that currently resides there, and due to Tennessee's tax laws which create advantageous tax results upon implementation of the Factoring Strategy. KFR will purchase the receivables of the aforementioned companies at an arm's length discount as determined by an E&Y economist as stated in the transfer pricing report. The selling corporations will receive an ordinary deduction equal to the amount such receivables were discounted. Conversely, KFR will recognize income upon collection to the extent the amount ultimately collected exceeds the original purchase price. This income will be subject to taxation in California, Illinois, Massachusetts, and Tennessee, as well as other unitary states. However, due to the favorable sourcing rules in these states, only a fraction of the income will be subject to tax. As a result, the vast majority of income generated by KFR should escape separate-state taxation. Furthermore, having KSS service and collect KFR's purchased receivables will preclude KFR from having nexus, based upon a physical presence, with numerous states.

82. The summary also included representations made by Kellwood upon which E&Y's advice depended, analysis concerning the impact of the implementation of the Factoring Strategy on Kellwood's state tax liability, and potential risks associated with the Factoring Strategy.

83. E&Y also included as part of the six binders a "Review of the Factoring Project," dated May 31, 2000. This document summarized E&Y's evaluation of Kellwood's operations from January 1, 2000 to May 31, 2000 to ensure that implementation of the Factoring Strategy followed expectations. E&Y concluded that if Kellwood properly implemented the Factoring Strategy and, after the reallocation of a management fee among those participating entities, Kellwood "should generate approximately all of [sic] state tax savings as presented by E&Y."

84. The majority of the other documents included in the six binders are memoranda, prepared by E&Y, analyzing specific aspects of the Factoring Strategy. E&Y considered the funding mechanism of KFR, the personnel of both KFR and KSS, prepared the corporate bylaws

of KFR and KSS, assisted Kellwood in obtaining board of director and shareholder approval, prepared minutes of initial organizational meetings for both KFR and KSS, and provided Kellwood with draft copies of intercompany agreements.

85. E&Y also considered the necessity of forming KSS. Since KFR would not be able to service the accounts receivable it purchased from Kellwood and other subsidiaries, E&Y concluded that Kellwood "will form Kellwood Shared Services (KSS) in Missouri to perform, or contract out, the credit and collect [sic] function for KFR in exchange for an arm's length fee." E&Y reasoned that the formation of KSS would: (1) limit KFR's nexus with several states; (2) provide a small state tax benefit as a result of the fee charged by KSS for its credit and collections services; and (3) allow Kellwood to better evaluate and manage its shared services concept.

86. E&Y determined the internal and external "substance items" that needed to occur to establish KFR and KSS as active subsidiaries. E&Y documented "a list of functions and activities that should be completed by KFR in order to fulfill the business purpose for which it has been created" and identified those substance items that Kellwood could implement "without significant disruption to operations" and those "not absolutely necessary to the successful implementation of the strategy." E&Y identified internal indicators such as signs, company manuals, and phone books, and external indicators such as stationery, business cards, and advertising.

87. E&Y also drafted a multi-page memorandum analyzing the "business purposes for the creation and contribution of assets to KFR and KSS and whether they are significant enough for the IRS to respect the formation of the entity and its operational substance for future transactions."

88. According to the memorandum, Kellwood's management identified the following business purposes for KFR:

> (1) The centralization of accounts receivable furthers the Company's objective to better manage and control working capital and provides a management tool (i.e., separate profit center) to measure and reward the success of the servicing and collection activities thereby improving Kellwood's management and control of working capital.
>
> (2) Kellwood's aging of accounts receivable continues to deteriorate as customers lengthen their payment cycles. It is a goal of Kellwood management to focus on this issue and reverse the current trend. Creation of KFR will facilitate this effort by focusing the accounts receivable function in an entity separate and apart from the operational units, and holding this function accountable to the goals set by management.
>
> (3) Segregating the accounts receivable servicing operations and financing operations from Kellwood's business units will allow the Company to better measure the true economic income associated with its various activities (i.e., the manufacturing and sale of goods, the financing of customer purchases, and the servicing of its loans to customers) and to better manage the performance of these various activities.
>
> (4) In conjunction with the revision of the Company's debt agreement, it is envisioned that the pooling of the accounts receivable together into a single factoring company will facilitate secured financing or possible securitization of the receivables at some point in the future.
>
> (5) Segregating the accounts receivable servicing operations and financing operations from Kellwood's business units will provide for a better measure of Kellwood's true economic income for which it has nexus in separate return states (i.e., it will provide a better measure of the income from manufacturing and sales activities with respect to which has established nexus in various states, as opposed to lending activities with respect to which it should not have nexus in the various states).
>
> (6) The formation of KFR will allow Kellwood to lower the overall administrative costs of managing the accounts receivable by centralizing the functions into a specialty area rather than keeping the function decentralized and handled by individuals without such expertise.
>
> (7) Through state and local tax savings that should be derived from the Company's restructuring of its accounts receivable operations, the Company will enhance earnings, cash flows, earnings per share, and shareholder value.

89. The business purposes for KSS set forth in the memorandum included the following:

> (1) Following the management decision to create a shared services function, the creation of KSS will facilitate this decision by setting the division separate and apart from Kellwood Company and other legal entities, thereby giving it autonomy to conduct the business for which it was created.
>
> (2) As the Company's other subsidiaries continue to migrate to the shared services platform, for financial accountability, this function needs to be managed and accounted for separate from the business units within Kellwood. The separate legal entity allows for arm's length charges to be utilized to charge for services performed on behalf of all business units, and will not thereby affect the financial performance of Kellwood to the detriment of other subsidiaries.
>
> (3) Cost control savings, that will be realized by each business unit, should be derived by centralizing administrative functions within a central location and managing those functions on a consistent and continual basis. This transaction allows the business units to focus on the business for which it was created, and allows KSS to focus on the business for which it was created.

90. E&Y concluded that these "business reasons, along with the reduction of state income taxes, should be sufficient to overcome any challenges the IRS may present in [Kellwood's] §351 contribution of assets to KFR and KSS." Furthermore, "[Kellwood's] transfer of assets to KFR and KSS should not reduce its federal income taxes, and therefore, the IRS will have no motive in challenging [Kellwood's] transaction."

91. E&Y also examined the Factoring Strategy from a state tax perspective. E&Y considered KFR's filing status, the apportionment details of KFR and KSS and the effect on Kellwood and other subsidiaries, and the sales and income tax nexus requirements of KFR and KSS. E&Y determined that Kellwood would realize the most tax savings in New York, followed by New York City, Massachusetts, Texas, Virginia, West Virginia, Georgia, and Pennsylvania. In addition, E&Y analyzed the "potential state challenges" resulting from the Factoring Strategy. With respect to New York, E&Y concluded that "[g]iven the arm's length nature of the sale of

accounts receivable and the economic substance of the new entities, it is more likely than not that New York will not successfully challenge the restructuring through forced combination."

92. E&Y drafted an 18-page memorandum, entitled "Kellwood Accounting Procedures Manual," which it "intended to provide accounting and tax reporting guidance to Kellwood Company relating to its formation of, and future transactions with, Kellwood Financial Resources, Inc. and Kellwood Shared Services, Inc." This memorandum details the accounting entries to be made by Kellwood to effect the Factoring Strategy, including the creation of an "Adjustment Division," described as follows:

> This Adjustment Division will be a separate accounting book located within [Kellwood's] general ledger and within the subsidiaries' ledgers which will allow [Kellwood] and its subsidiaries to properly reflect the transferring of the accounts receivable and cash to KFR while maintaining the integrity of its established accounting and cash collection systems. When a sale is made, the generation of the invoice and the recording of the sale will continue to be done on the operational books. A recording will be made on a weekly basis within the appropriate Adjustment Division to transfer the accounts receivable and cash from the operational books to KFR's books. This transfer will only be evident on the Adjustment Division books. Therefore, at any given time, the books of the business units will remain intact. When taken as a whole, the business unit and the Adjustment Division together will produce the business unit's financial position including the impact of the factoring activity on a tax basis. When the business unit's books are combined with the Adjustment Division's and KFR's books, management reporting will be intact for financial reporting purposes.

93. E&Y explained that "essentially, [Kellwood's] and its subsidiaries' daily accounting process will be unchanged by the accounts receivable reorganization . . ." and that "the entries simply are intended to transfer to KFR all of [Kellwood's] accounts receivable-related activities and entries (e.g., collections and bad debt write-offs) and record the factoring related activities so as to leave the business units' books intact." E&Y noted that "[t]he existing banking structure and physical flow of cash will remain unchanged as a result of the restructuring."

94. In the memorandum, E&Y recognized that "[a]fter the restructuring, all Selling Corporations will continue to make sales, establish payment terms, issue invoices and credit memos, and resolve charge-back disputes as they currently do," but that KFR would not have the ability to service and collect on the accounts receivable. Therefore, E&Y explained, "KFR will contract with KSS to service and collect the accounts receivable it purchases in the factoring transaction. KFR will pay KSS a servicing fee at a fair market rate in an arm's length transaction. Business units that do not have shared services perform their credit and collection functions will continue to service their own accounts receivable and will be reimbursed by KSS for these services . . . ." E&Y prepared an Excel spreadsheet to assist in calculating the necessary weekly and monthly entries and support documents for the transactions.

95. Kellwood compensated E&Y for the Factoring Strategy on the basis of 40 percent of the amount of Kellwood's first full-year's tax savings.

Formation of KFR and KSS

96. On November 23, 1999, consistent with the Factoring Strategy and in order to continue the direction toward centralization of financial administration and managerial functions, Kellwood management authorized the formation of two wholly-owned subsidiaries, Kellwood Financial Resources, Inc. (KFR) and Kellwood Shared Services, Inc. (KSS). As indicated by the minutes of the meeting of Kellwood's board on November 23, 1999, KFR was formed to provide factoring services to Kellwood for its receivables, and KSS was formed to provide centralized payroll, accounts payable and accounts receivable functions.

97. On December 9, 1999, KFR was incorporated under the Tennessee Business Corporation Act as a wholly owned subsidiary of Kellwood. KFR was incorporated in Tennessee because the greatest number of credit and collection employees were already located

in Tennessee. The tax implications of incorporating in Tennessee as noted in the E&Y memoranda were also a factor in the decision to incorporate KFR there.

98. At the time of KFR's formation, Lawrence Hummel was elected as vice president. The officers and directors of KFR followed the corporate formalities: they adopted bylaws, obtained a federal employer identification number, obtained an employer number from the State of Tennessee Department of Labor and Workforce Development, created letterhead for correspondence, attended annual meetings of the board of directors or executed consents in lieu of the annual meetings, and opened a bank account for payroll.

99. In connection with the reorganization, the 14 employees of Kellwood's Sportswear Division claims department in Jackson, Tennessee, who were engaged in charge-back processing, were transferred to the staff and payroll of KFR. In 2002, KFR had as many as 30 credit and collection employees. KFR also entered into a lease agreement with Kellwood to lease the facility in Jackson, Tennessee, to house the KFR employees.

100. The formation of KFR and subsequent purchase of Kellwood's accounts receivable accomplished Kellwood's stated business objective of isolating the ownership of the accounts receivable into a single entity. The transfer of title to the receivables and the advance of the value of the receivables (less the discount rate) by KFR at the time of the transfer distinguished the centralization of Kellwood's credit and collection function under KFR from centralization under the Shared Services Division. KFR acted as an inside factoring company for Kellwood.

101. On December 31, 1999, Kellwood purchased all the accounts receivable on the books of several of its subsidiaries. On January 1, 2000, Kellwood contributed the purchased accounts receivable, plus its own accounts receivable, to KFR in exchange for the stock of KFR.

102. On January 31, 2000, KFR purchased all of the accounts receivable existing on the date of the agreements and accounts receivable created thereafter on a nonrecourse basis from Kellwood and its subsidiaries Halmode Apparel, Koret of California, American Recreation Products and Fritzi California. On January 5, 2003, KFR purchased all of the accounts receivable existing on the date of the agreements and accounts receivable created thereafter on a nonrecourse basis from the following business units: Biflex International, Dorby Frocks, Gerber Children's Wear and Auburn Hosiery Mills. On May 10, 2004, KFR purchased all of the accounts receivable from New Campaign existing on the date of the agreement and accounts receivable created thereafter on a nonrecourse basis. Pursuant to all of these agreements, following the initial purchase, KFR continued to purchase the receivables on a weekly basis.

103. KFR purchased net receivables from the business units. That is, gross receivables (i.e., the face value of the invoice) less charge-back reserve, trade discounts reserve, over-billing reserve and return reserve. These reserves were estimated at the time of the transfer to KFR. Such estimates were later corrected when customers made actual payments. This procedure did not affect the factoring discount. Under the terms of the agreements with the business units, KFR was required to purchase all of the business units' net receivables. The purchase price for the receivable purchased by KFR was the face value of the net receivables less the discount rate. The agreements between KFR and the business units required that KFR pay the purchase price for the receivables at the time of transfer of the receivables to KFR.

104. KFR purchased the receivables of Kellwood and its subsidiaries slowly over time so that there was ample time to train personnel to service the accounts. KFR purchased the receivables of some of Kellwood's subsidiaries at a later date because Kellwood did not previously own those subsidiaries.

105. Kellwood entered into a Revolving Credit Agreement with KFR on January 1, 2000, pursuant to which Kellwood loaned KFR the funds necessary to purchase receivables from Kellwood and its subsidiaries. KFR required funds to purchase the accounts receivable of Kellwood and its subsidiaries and borrowed from Kellwood when it was created. Also on January 1, 2000, KFR entered into a Revolving Credit Agreement with Kellwood which provided that Kellwood could borrow money from KFR when it began generating income. After KFR began to generate income, KFR loaned funds to Kellwood.

106. The record is unclear as to how long KFR borrowed from Kellwood and when Kellwood began to borrow from KFR. According to its federal form 1120, Kellwood reported KFR incurred interest expenses of $4,240,018.00 and $2,412,864.00 for the fiscal years ended January 31, 2001 and January 31, 2002, respectively. As of March 9, 2002, KFR owed Kellwood $12,992,998.79.

107. As the legal owner, KFR bore all the risks associated with the accounts receivable including the risk of nonpayment.

108. KFR was responsible for setting the total credit limits for Kellwood's customers and the individual credit limits for Kellwood's business units, which is typical of an independent factoring company. The credit manager of KFR gained information about the credit situation of Kellwood's customers through membership in a number of industry groups and organizations and subscription to various credit rating organizations. The information obtained was used to identify "monitor" and "risk" accounts and to set credit limits.

109. When customers were designated as "risk" accounts by KFR personnel, active negotiations were undertaken to reduce the terms and the amount owed to Kellwood, and a checks and balances system was put in place to insure that new credit was not extended until

payments were made on existing accounts receivable. When customers were designated as "monitor" accounts, KFR personnel would monitor their credit balances more closely and more frequently and would attempt to obligate the customer to make payments prior to shipping goods. Despite the additional workload associated with "risk" and "monitor" accounts, KFR purchased those accounts receivable without recourse.

110. KFR routinely prepared monthly reports summarizing the actions that KFR took in relationship to Kellwood's customers. When customers were in financial trouble, KFR personnel would very closely monitor the relationship and would issue periodic status reports. If a significant customer was facing financial difficulties, KFR personnel would meet with them and attempt to limit Kellwood's financial exposure while preserving the relationship with the customer.

111. KFR was also responsible for collecting the amount due from customers. If the customers had either large or overdue balances, KFR personnel would contact them once a day or several times a week. KFR was also responsible for monitoring the pipeline inventory and making sure that the business units did not ship more goods to the customer until they collected corresponding amounts from current receivables.

112. KFR employees were also responsible for dealing with customer requests for charge-backs, a common practice in the apparel industry. Customers would regularly attempt to charge Kellwood for any deviation from the customer's policies such as shipping the products early or placing labels in the wrong place. Processing requests for charge-backs was an integral part of the credit and collection function because charge-backs had a significant impact on Kellwood's profits and losses. The percentage of sales price that was ultimately charged back to Kellwood ranged from two to seven percent. Customers also would use charge-backs

as a method of delaying payment; they would refuse to pay an invoice until all of the requests for charge-backs associated with that invoice had been resolved.

113. KFR was also responsible for negotiating the terms of the sale (i.e., how long the customer had to remit payment). Prior to the centralization of the credit and collection function, the business units had widely divergent terms with the same customers. However, after the credit and collection function was centralized, the terms became more standard.

114. Contemporaneous with the formation of KFR, Kellwood formed another wholly-owned subsidiary to integrate the payroll, accounts payable, accounts receivable, credit and collection activities and other similar financial process improvement functions into one entity, Kellwood Shared Services, Inc. (KSS). On December 6, 1999, KSS was incorporated under the General Corporation Laws of the State of Delaware. At the time of KSS's formation, Lawrence Hummel was elected as vice president. According to Mr. Hummel, KSS "was formed to be the legal entity that was dealing with the financial behind the curtain activities that Kellwood was consolidating for [Kellwood's] divisions and subsidiaries."

115. Effective as of January 1, 2000, Kellwood transferred all of the assets, liabilities, and personnel of the shared services center to KSS in exchange for the stock of KSS. It was Kellwood's intent, by this transfer, to consolidate its payroll, accounts payable, credit and collections and process improvement functions in its Kellwood Shared Services facility in the St. Louis area. Jerry Betro, who was responsible for credit and collection in the Shared Services Division, ran the credit and collection operation for KSS.

116. KFR could not service its purchased receivables on its own. Accordingly, effective as of January 31, 2000, KFR entered into a Receivables Collection and Administrative Services Agreement with KSS whereby KSS would provide receivables collection services for KFR for a

fee based upon the actual cost of the services plus eight percent. The rate of cost plus eight percent was determined based on a study completed by E&Y. In early 2004, once KFR's activities and employees were relocated from Tennessee to Missouri, KSS employees located in Missouri who had been providing services to KFR were transferred into KFR and the administrative services agreement was cancelled. At that point, then, KFR performed both the credit and collection function and the factoring function.

117. Kellwood engaged E&Y to compute an arm's length range for the cost markup that should be charged for the provision of credit and collection, accounting/data processing, payroll, human resources, and related services provided by KSS. E&Y concluded that an arm's length range for the markup was 1.08% to 18.72% with a median of 7.92% and that the most reasonable figure to choose was 8%. In accordance with the E&Y report, Kellwood and KFR compensated KSS for the services it provided at a rate of actual cost plus eight percent during the years at issue. The Division did not challenge the eight percent markup at the hearing, nor did its experts.

118. According to E&Y's memorandum, entitled "Engagement Summary," E&Y reviewed, among other services, "the provision of credit and collection services by KSS to KFR" and "the provision of credit and collection services by Kellwood, Fritzi, Halmode and ARP to KSS." Kellwood, Fritzi, Halmode, and ARP performed their own credit and collections functions from the onset of the Factoring Strategy and billed KSS for these services. As of December 7, 2005, KFR did not perform credit analysis for ARP. Kellwood intended that KFR would perform ARP's credit analysis sometime in the 2006 fiscal year.

119. As of about January 2000, employees responsible for the credit and collection function were 5 or 6 high level individuals employed by KSS and charged to KFR; 14 employees

in Tennessee employed and paid by KFR; and several lower level individuals employed by the various divisions and charged to KFR.

120. Effective as of January 1, 2000, Kellwood, KFR, American Recreational Products, Inc., Fritzi California, Inc., Halmode Apparel, Inc., Koret of California, Inc., MJF Imports, Inc., New Campaign, Inc. and Robert Scott & David Brooks Outlet Stores, Inc., entered into an Administrative Services Agreement with KSS whereby KSS agreed to provide payroll, accounts payable, credit and collections, and process improvement services for a fee based upon the actual cost of the services plus eight percent. The credit and collections services referenced in this agreement were the same credit and collections services KFR provided to Kellwood and its other subsidiaries.

121. The officers and directors of KSS followed corporate formalities: they adopted bylaws, obtained a certification to do business in Missouri, obtained federal and state employer identification numbers, created letterhead for correspondence, attended annual meetings of the board of directors or executed consents in lieu of the annual meetings, and opened a bank account for payroll.

122. Effective January 31, 2000, Kellwood entered into an Administrative Services Agreement to provide legal, treasury, cash management, corporate accounting, tax, human resources, risk management, information systems support, and other corporate administrative services to KFR, KSS, and other subsidiaries. Kellwood charged the subsidiaries actual cost plus eight percent for these services.

The Ernst & Young Reports

123. As part of the Factoring Strategy, E&Y prepared a report, entitled "Kellwood Financial Resources, Inc. Analysis of Certain Intercompany Transactions Under Internal Revenue Code § 482 for the Tax Year Ending January 31, 2001" and dated March 2000 (E&Y 2001 Report). E&Y described the report as "a transfer pricing study to assist [Kellwood] in establishing and documenting arm's length terms for the provision of accounts receivable factoring services by Kellwood Financial Resources, Inc. ('KFR') to Kellwood and certain of its operating subsidiaries for the tax year ending January 31, 2001."

124. Mr. Hummel met with E&Y personnel regularly as they were conducting their study so that he would understand the process and the assumptions that E&Y personnel were making in reaching their conclusions. After establishing the qualifications of the E&Y personnel preparing the report, Mr. Hummel relied on their professional expertise in determining the arm's length discount rate for KFR's purchase of receivables from Kellwood since neither he nor anyone at Kellwood was an expert in the field of transfer pricing.

125. In this report, E&Y characterized the transactions between KFR and Kellwood as the provision of services. Utilizing internal company data and, to a lesser extent, data from third-party factoring companies, E&Y calculated the compensation to be paid to KFR for its factoring services based upon: (1) the time value of money; (2) bad debt exposure; (3) collection expense; and (4) a fixed fee. E&Y determined an arm's length value for each of these components as follows: (1) time value of money, 1.83 percent, (2) bad debt exposure, .24 percent, (3) collection expense, .10 percent, and (4) fixed fee, .89 percent. E&Y totaled these components and concluded that the arm's length terms for the sale of receivables from Kellwood and its operating subsidiaries to KFR entailed KFR purchasing the receivables from the seller at a discount of 3.06

percent off of the face value of the receivables. The report recommended that for "ease of administration and to be conservative [Kellwood] may wish to establish a discount of 3 percent."

126. Mr. Hummel accepted E&Y's recommendations and decided to use a three percent discount rate.

127. In December 2002, Kellwood engaged E&Y to update the E&Y 2001 Report for the fiscal year ending January 31, 2003. This updated study was intended to take into account changes in economic conditions that would affect the discount rate. John L. Gegg, Kellwood's tax manager, provided E&Y personnel with the information requested and verified that E&Y personnel were using the correct facts in their transfer pricing study.

128. By a memorandum dated January 15, 2003, E&Y concluded that the arm's length discount rate should be in the range of 2.13 percent to 2.69 percent The 2.13 and 2.69 percent figures were three-year averages of lower and upper quartile discount rates of purportedly comparable companies. Such discount rates had a commission component and a time value of money component. The 2.13 percent amount consisted of an average commission rate of .60 percent and an average time value of money rate of 1.53 percent. The 2.69 percent upper quartile amount consisted of an average commission rate of .83 percent and an average time value of money rate of 1.86 percent. Kellwood used a rate of 2.41 percent for the receivables purchased by KFR for the year ending January 31, 2003, which was the average of the lower and upper quartile discount rates identified by E&Y. By extrapolation, the 2.41 percent rate consisted of a commission rate of .715 percent and a time value of money rate of 1.695 percent (that is, the average of the commission and time value of money rates which comprised the lower and upper quartile discount rates).

129. Although KFR agreed to the reduction in the discount based on economic conditions, Mr. Hummel could not recall what changes in economic conditions necessitated a reduction to the discount rate. Nor could Mr. Hummel remember whether KFR purchased the accounts receivable at the 2.4 percent discount rate during the fiscal year ended January 31, 2003. Mr. Hummel also could not remember whether KFR and Kellwood amended the Receivables Purchase and Sale Agreement to reflect the lower rate.

130. Kellwood management relied on E&Y's professional expertise in the preparation of the second transfer pricing report and on its recommendation as to the range of the arm's length discount rate because no one at Kellwood had the transfer pricing expertise to determine the proper rate.

131. E&Y prepared a report, entitled "Kellwood Financial Resources, Inc. Analysis of Certain Intercompany Transactions Under Internal Revenue Code § 482" and dated January 31, 2003 (E&Y 2003 Report). E&Y described this report as "provid[ing] arm's length pricing recommendations with respect to certain intercompany transactions amongst Kellwood Company ('Kellwood') affiliates for the tax year ending January 31, 2003."

132. In the E&Y 2003 Report, E&Y states it applied two methodologies in determining an arm's length consideration for the transactions between KFR and Kellwood: (1) the Comparable Uncontrolled Transaction (CUT) method and (2) an "unspecified method."

133. According to E&Y, "[t]he CUT method evaluates whether the amount charged in an intercompany transaction is at arm's length by reference to the amount charged in comparable uncontrolled transactions." The CUT method is one of the methods prescribed by Treasury Regulation § 1.482-4(a) for determining arm's length consideration for transfers of intangible

property. E&Y selected the intangible methods as the more appropriate means to analyze KFR's factoring services.

134. In applying the CUT method, E&Y identified five factoring agreements with which to compare the transactions between KFR and Kellwood. After making an adjustment for "days' float," E&Y concluded that the arm's length range of discount rates for the factoring transactions should be 2.13 percent to 2.69 percent.

135. Similar to the E&Y 2001 Report, in the E&Y 2003 Report, E&Y based its "unspecified method" upon: (1) the time value of money; (2) bad debt exposure; (3) collection expense; and (4) a fixed fee. Internal company data provided the majority of the information used by E&Y to apply this method, along with information from third-party factoring companies. E&Y concluded that the arm's length range of discount rates should be 1.82 percent to 2.61 percent.

136. As noted, E&Y recommended that KFR purchase Kellwood's accounts receivable at a discount from face value in the range of 2.13 percent to 2.69 percent, explaining that its

> recommendations are primarily based on the results of the CUT analysis. The CUT method generally involves fewer and less significant adjustments to comparable data than other methods and is therefore generally accepted as the most reliable measure of an arm's length result. In addition, there is significant overlap between the results derived by the two methods and, therefore, no need to reconcile them.

Success of Centralization in KFR and KFS

137. In 2003, Kellwood hired Protiviti, a risk consulting group, to evaluate the effectiveness of the functions that were centralized in KFR. Protiviti concluded that Kellwood had a highly effective collection process. The Protiviti study indicated that "Credit and Collection also utilizes a number of best practices to produce excellent results despite the

encumbrance of multiple systems." Protiviti concluded that 4 of 15 measures of KFR's credit and collection function ranked in the first quartile; 8 measures ranked in the second quartile, of which 5 were near the top of the second quartile; only 3 measures were in the third quartile; and none were in the fourth quartile.

138. The centralization of Kellwood's credit and collection function in KFR, a continuation of a process that began with the implementation of the Shared Services Division in 1998, resulted in dramatic improvements. As a result of the centralization, Kellwood management was able to obtain and review up-to-date consolidated information regarding its customers, which resulted in better control of how much credit was extended to any one customer and better control of pipeline inventory.

139. The centralization of Kellwood's credit and collection function in KFR resulted in more consistent terms with customers throughout the different business units. The centralization also accelerated the collection of Kellwood's accounts receivable, thus reducing Kellwood's DSOs, which provided an additional cash flow. DSOs dropped from approximately 62 days in January 2001 to less than 56 days in January 2004, based on data which includes subsidiaries that did not sell their receivables to KFR. In Mr. Hummel's opinion, "KFR and the centralization of the receivables was the single most important element in the reduction of the accounts receivables days outstanding."

140. The centralization of Kellwood's credit and collection function in KFR also had a positive impact on Kellwood's ability to manage its inventory. Kellwood management had up-to-date consolidated data to better manage the production of inventory by the business units.

141. Kellwood also reaped benefits from separating the business unit employees from the credit and collection function. By separating the authority of the credit and collection department

from the sales departments, salesmen became better negotiators with their customers and were more able to deflect customer pressure to change the sale terms. The salesmen were now able to tell customers that they did not have the authority to change the terms.

142. The centralization also eliminated some of the inefficiencies associated with multiple parties dealing with the same customers. Kellwood was able to assign a specific credit group within KFR to a customer, which eliminated the need for multiple people to relearn the same characteristics about each customer.

143. The centralization of the credit and collection function allowed Kellwood to reduce head count, which resulted in significant cost savings. Between fiscal year 2002 and September of 2006, Kellwood reduced its head count in the credit and collection area by 25 people at the business unit level, with an increase in head count of only 5 people at KFR. The net decrease of 20 people resulted in a savings of approximately one million dollars.

144. As of the end of the 2002 fiscal year, the last year of the audit period, 26 credit and collections employees remained in the business units and 30 credit and collections personnel were employed at KFR. The credit and collections employees remaining with the business units were likely involved in charge-back functions. The charge-back function migrated to KFR on a different basis than the credit function because of the number of employees necessary to perform this function.

145. As a result of the centralization, Kellwood's cash flow improved significantly. According to a Kellwood fiscal year 2002 report, by the third quarter of 2002, the centralization of the credit and collection functions in KFR enabled Kellwood to reduce company-wide credit and collection expenses by approximately \$2.8 million annually. The centralized credit and collection department reduced company-wide interest expense by approximately \$1.2 million

annually and freed up approximately $15 million in cash. The savings were the result of improved collection effectiveness. For the first eight months of 2002, collection effectiveness averaged 98 percent, compared to less than 93 percent prior to any centralization. The improvement is attributable to implementing best practice collection procedures and leveraging the strength of Kellwood.

146. According to an executive summary of Kellwood's credit and collections planning for the 2003 fiscal year, in comparing the 2001 fiscal year with the 1997 fiscal year, Kellwood experienced "substantial savings from the elimination of factors at six business units - Sag Harbor, Koret, New Campaign, Romance du Jour, Democracy and Dorby."

147. Kellwood terminated Koret's third-party factoring agreement because cheaper funds were available through Kellwood's credit facility. New Campaign did not sell its accounts receivable to KFR during the audit period. Kellwood acquired Dorby, Romance du Jour, and Democracy in the fiscal year ended January 31, 2001. Darby did not begin to sell its accounts receivable to KFR until January 2003. There is no evidence in the record that Romance du Jour or Democracy sold their accounts receivable to KFR.

148. Mr. Hummel was familiar with those six factoring agreements "generically," but could not recall specific terms. He believed that the percentage of receivables advanced in those agreements was approximately 75 percent. Those six business units terminated their factoring agreements when KFR became "effective" so that they could rely on KFR.

149. According to Mr. Hummel, Kellwood could have achieved its objective to better manage and control working capital by improving cash flow through better management and efficiency in credit and collection without selling its accounts receivable to KFR. Mr. Hummel also testified that it was not necessary for Kellwood to form KFR to reduce its administrative

costs, that is, centralization of Kellwood's credit and collections functions in a centralized division would have accomplished the same goal. According to Mr. Hummel, a "significant reason" why Kellwood transferred its accounts receivable to KFR was to save taxes. Managing the company's expenses, including taxes, was part of Mr. Hummel's job as a Kellwood executive. Mr. Hummel did not know how much Kellwood saved in taxes by implementing the factoring strategy.

150. According to Mr. Hummel, Kellwood chose to implement the factoring strategy because it met Kellwood's objectives with respect to centralization of credit and collection and also with respect to asset-backed securitization. Kellwood evaluated factoring based on E&Y's proposal.

151. In January 2004, KFR's board of directors recommended a $20 million dividend to Kellwood. According to Mr. Hummel, the excess cash resulted from more efficient collection of the accounts receivable and the profitability of KFR. KFR's profitability resulted from its factoring income; it did not have any other income.

152. Mr. Hummel did not know if Kellwood, on a stand-alone basis, incurred taxable losses due to the expense of factoring its accounts receivable. He also did not know whether the money Kellwood saved as a result of its improved DSOs was less than the cost of factoring.

153. On March 7, 2002, Kellwood's chief financial officer, Lee Capps, reported to Kellwood's audit committee that "[t]he continued consolidation of credit and collection activities within Kellwood Shared Services has improved the accounts receivable situation."

2002 Pursuit of Asset-Backed Securitization Transaction

_____154. In addition to tax savings Mr. Hummel also testified that Kellwood formed KFR for "financing flexibility," that is, asset-backed securitization. Mr. Hummel identified such financing flexibility, along with tax savings, as the principal reasons for the formation of KFR.

155. Kellwood senior management gave serious consideration to entering into an asset-backed securitization transaction as an additional source of financing. Kellwood spent months negotiating with its lenders in 1999 to carve out $75 million of receivables from the revolving credit agreement to allow Kellwood to do a securitization transaction. As noted previously, Kellwood management identified the possible facilitation of a securitization transaction as a business purpose for the formation of KFR and the transfer of receivables from Kellwood to KFR. In addition, in 2000 Kellwood management had received a presentation from Bank One Company in September 2000 on the "Fundamentals of Securitization."

156. In December 2002, Kellwood treasury personnel forecasted future cash flow and borrowing needs and became concerned that Kellwood might need additional cash even if it did not make any additional acquisitions.

157. Kellwood personnel evaluated the asset-backed securitization proposals that it received from Banc One and Scotia Capital. Kellwood personnel analyzed the costs of an asset-based securitization program and contrasted it with other types of financing. Kellwood personnel also analyzed whether the addition of an asset-backed securitization facility would jeopardize any of its bank covenant agreements. After performing a cost/benefit analysis of entering into an asset-backed securitization program, treasury personnel recommended that Kellwood put an asset-backed securitization facility in place in order to give Kellwood a buffer in the event of unforeseen expenditures.

158. Kellwood treasury personnel indicated that the "Administrative Fee" also known as the "Program Fee," had been reclassified from a fixed fee to a variable (usage) fee. The result of this change was that the additional expense of approximately $130,000.00 for an unused asset-backed securitization program disappeared, and therefore, establishing the asset-backed securitization facility was not any more expensive than having additional commitments in the 2002 Credit Facility. If the fee had not been reclassified, the ABS facility would have been more expensive than the credit facility. Banc One indicated that it could offer a slightly better interest rate than Scotiabank, so treasury personnel recommended establishing the $75 million asset-backed securitization facility with Banc One.

159. On February 4, 2003, John Bruenger, assistant treasurer of Kellwood, entered into an agreement with Banc One whereby Banc One would provide Kellwood with an asset-backed securitization facility under certain terms and conditions.

160. As of April 21, 2003, Kellwood intended to implement the ABS program. In the treasury department memorandum indicating Kellwood's intention, John Bruenger states that the accounts receivable to be made part of the ABS program included Sag Harbor, Menswear, Intimate Apparel Group, and Kellwood Distribution Division. Sag Harbor, Menswear, Intimate Apparel Group, and Kellwood Distribution Division are divisions of Kellwood.

161. At some point thereafter, Kellwood management became concerned about the securitization transaction with Banc One after the bank altered the terms of the transaction by reducing the amount of money that Kellwood would be able to borrow against its receivables. Banc One proposed an advance rate of 50 percent or less, which meant that in order to borrow $75 million, Kellwood would need to secure an average of $150 million of its accounts receivable. Banc One also added covenants to the agreement that were unacceptable to

Kellwood. Additionally, Kellwood was advised by Bank of America that an ABS was “not the most efficient way to raise long-term capital.” As a result of the changes to the terms, in June 2003 Kellwood decided not to enter into an asset-backed securitization transaction.

162. Kellwood management was aware that KFR was not a bankruptcy-remote entity at the time it was created and that securitization required a bankruptcy-remote entity.

Expert Testimony Regarding Business Purpose and Economic Rationale

163. Kellwood retained Deloris R. Wright, Ph.D. (Dr. Wright) to render an expert opinion about the arm’s length factoring fee for the factoring transactions between KFR and Kellwood (***see*** Findings of Fact 189-198). Dr. Wright testified that part of her evaluation as an economist of an intercompany transaction requires an analysis of whether the transaction has a business purpose and has substance, which examines the functions and risks of the entity, and what value it adds. If the transaction lacks either a business purpose or substance, then her analysis of the transaction ends. Dr. Wright’s analysis with respect to economic substance focused on the entities, that is, “whether or not KFR would be an entity that would be respected for tax purposes.”

164. Dr. Wright performed a detailed analysis of the KFR transaction, examining documents and intercompany agreements and conducting interviews. Dr. Wright concluded that Kellwood’s business purposes for the formation of KFR were a logical step in its centralization of the credit and collection function and to provide a way to facilitate a securitization of its accounts receivable. According to Dr. Wright, these business purposes were typical of other situations Dr. Wright had analyzed and were sufficient to justify continuing her arm’s length analysis.

165. Dr. Wright's opinion concerning business purpose was not affected by the fact that Kellwood did not securitize its receivables, but would have been affected if there was insufficient evidence that the company was serious in its consideration of a securitization. In Dr. Wright's experience, companies often consider transactions that do not ultimately take place.

166. Concerning substance, Dr. Wright concluded that KFR had substance, performed the functions and assumed the risks of a factor, and added value. Dr. Wright based this conclusion in part on the fact that KFR had a significant number of employees doing the KFR functions.

167. The Division retained Dr. Alan C. Shapiro, Ph.D., to analyze the transfer of accounts receivable from Kellwood to KFR and other transactions related to the accounts receivable between Kellwood and its subsidiaries. Dr. Shapiro also analyzed the avowed business purposes of the receivables transactions. Dr. Shapiro prepared a report entitled "Economic Analysis of Kellwood Company's Transfer of Accounts Receivable to Kellwood Financial Resources," revised February 15, 2007 (the Shapiro Report).

168. Dr. Shapiro is the Ivadelle and Theodore Johnson Professor of Banking and Finance at the Marshall School of Business, University of Southern California. Prior to joining the Marshall School, Dr. Shapiro taught at numerous other universities and has also conducted many in-house training and executive programs in corporate finance and international finance and economics for corporations, government agencies, and law firms. Dr. Shapiro has published several books on corporate finance and many articles in academic and professional journals. Dr. Shapiro has also written in the area of securitization. In 1993 Business Week named Dr. Shapiro one of the ten most in-demand business school professors in the United States for in-house corporate executive education programs.

169. Dr. Shapiro based his opinions in the Shapiro Report on his professional knowledge and experience and certain documents provided to the Division during and after the audit. Dr. Shapiro testified at hearing and was accepted as an expert in economics and corporate finance.

170. In the Shapiro Report, Dr. Shapiro reviewed the factoring industry and determined that factoring may make economic sense for those companies that "have limited access to other sources of financing, have high capital requirements, have a lot of capital tied up in accounts receivable, have few sources of credit information regarding their customers, do not benefit from the retention of control over trade credit policies, outsource their sales functions, are not well-equipped to bear risk, and whose receivables are risky." Dr. Shapiro also determined that "factoring may not make economic sense for a company that has access to other sources of capital, has low working capital requirements, has a small number of large customers (making customer relationships and retention of control over trade credit policies more valuable as well as simplifying the gathering of credit risk information), uses its own sales force, and either is well-equipped to bear risk or has receivables that carry little risk."

171. Dr. Shapiro concluded that "[f]actoring did not make economic sense for Kellwood due to its access to other sources of capital that were much less expensive, its reliance on a small number of large customers, the lack of risk associated with its receivables, and the importance of information sharing between its selling and credit policy personnel."

172. Dr. Shapiro analyzed the business purposes provided by E&Y in its "Business Purpose" memorandum, dated December 31, 1999, which was provided to the Division during audit. Dr. Shapiro concluded that there was no connection between E&Y's listed purposes and the factoring transactions. He also concluded that no actual segregation of the accounts receivable occurred; that is, the only change from the status quo was that KFR would now own

the receivables. Dr. Shapiro also looked at E&Y's stated purposes relating to securitization and found no evidence in the documents he reviewed that KFR was a bankruptcy remote entity or that KFR had the ability to securitize Kellwood's accounts receivable.

173. As a result of his analysis, Dr. Shapiro concluded that the transfers of title to the accounts receivable to KFR lacked economic rationale.

174. In his report, Dr. Shapiro also concluded that there was no economic rationale or business purpose for centralizing Kellwood's credit and collection function. In reaching this opinion summarized in his report, Dr. Shapiro believed that the principal reason Kellwood had entered into the transactions was to save taxes.

175. After hearing testimony and reviewing documents, Dr. Shapiro changed his expert opinion to conclude that there was an economic rationale and business purpose for the centralization of Kellwood's credit and collection functions. Dr. Shapiro conceded that he had "heard testimony and had the opportunity to look at some documents which certainly suggested to me that Kellwood was able to achieve a variety of cost savings and cash generation through the centralization of credit, the credit and collection functions."

176. In reaching the conclusion contained in his report, Dr. Shapiro admitted that he had relied on E&Y documents, some of which were not accurate, and that he had not taken into account that Kellwood's different business units had common customers which led to economies of scale in centralizing the credit and collection function.

177. Dr. Shapiro did not change his opinion that transferring title to Kellwood's receivables to KFR lacked an economic rationale and a business purpose.

178. Dr. Shapiro believed that in late 2002 Kellwood needed additional sources of funds and was seriously considering securitization. Dr. Shapiro also acknowledged that Kellwood

made a serious attempt to compare the costs of financing via a line of credit, which he presumed was Kellwood's principal alternative, with the cost of the securitization transactions proposed by Scotia Bank and Banc One. In contrast, testifying that he did not see documents evidencing a similar analysis regarding a possible securitization transaction at the time KFR was set up, Dr. Shapiro concluded that Kellwood was not serious about using KFR as a vehicle for securitization. This conclusion impacted Dr. Shapiro's opinion that the KFR transactions lacked a business purpose and an economic rationale.

179. Dr. Shapiro acknowledged that Kellwood had negotiated a $75 million carve-out of accounts receivable from its bank credit agreement in August 1999 to allow Kellwood to do a securitization transaction and that the August 1999 credit agreement Kellwood entered into with its bank was negotiated for a significant amount of time prior to that date.

180. Dr. Shapiro testified that a company could outsource its credit and collections function without selling its accounts receivable. Dr. Shapiro explained that accounts receivable are different from tangible commodities in that accounts receivable are promises to pay. A company can transfer information about its accounts receivable, title to those receivables, or both. To engage in credit and collections, all a company needs to transfer is information about the receivables, not title.

181. As an example, Dr. Shapiro noted a factoring agreement involving the Tommy Hilfiger Corporation pursuant to which Hilfiger's factor did not provide financing, only credit and collections services. That is, upon collection of the receivables the factor would provide the collected cash to Hilfiger, but it did not take title to the accounts receivable until it actually paid Hilfiger.

182. Dr. Shapiro concluded that Kellwood could have centralized its credit and collections functions without having to transfer title to its accounts receivable to KFR and, in fact, did this in 1998 when it started the shared services division to provide centralized credit and collections services.

183. Dr. Shapiro testified that any shifting of risk associated with selling Kellwood's accounts receivable to KFR was ultimately shifted back to Kellwood since Kellwood financed KFR's purchase of the accounts receivable. In addition, Dr. Shapiro noted that even when KFR began to loan money to Kellwood under the Revolving Loan Agreement, Kellwood ultimately bore the risk, that is, had it not been for the factoring arrangement Kellwood would have retained those funds.

184. Dr. Shapiro explained that a bankruptcy-remote entity is an entity "set up to receive assets from another entity. The bankruptcy-remote entity, or SPE, would issue securities. The investors in those securities would look solely to the cash flow generated by those securities for satisfaction of its debts." Dr. Shapiro noted that a bankruptcy remote entity can only engage in activities granted to it in its organizational documents and concluded that, in his opinion, KFR would not qualify as a bankruptcy-remote entity because it engaged in credit and collections activities.

185. Dr. Shapiro agreed that companies do look for alternative sources of financing. In his opinion, if Kellwood was serious about using KFR as a vehicle for securitization he would have expected to see analysis, that is, a comparison of the costs of asset backed securitization with the costs of financing with a line of credit, similar to the analysis Kellwood conducted in 2003 when it received offers from Scotia Bank and Banc One.

186. Dr. Shapiro further testified that Kellwood did not need to transfer title to its accounts receivable to KFR to engage in securitization. A company could centralize its credit and collections function to determine the quality of its receivables and then transfer only those creditworthy accounts receivable in the amount necessary to obtain the amount of desired financing to an asset-backed securitization facility. Instead of transferring title first to KFR and then from KFR to a bankruptcy-remote entity, Kellwood could have transferred title directly to a bankruptcy-remote entity and avoided the additional step of transferring title to KFR. In Dr. Shapiro's opinion, Kellwood created a "convoluted structure" to engage in asset-backed securitization.

187. In Dr. Shapiro's opinion, considering that, through 2003 Kellwood loaned KFR the money it used to buy Kellwood's receivables, KFR was not a source of financing for Kellwood because of the circularity of cash flows. Dr. Shapiro also testified that, even after KFR became a net lender to Kellwood, KFR was not a source of net new financing for Kellwood.

188. In response to the Shapiro Report Dr. Wright prepared a report entitled "Review of Expert Report of Allan [sic] C. Shapiro, Ph.D.," revised March 15, 2007 (the Wright-Shapiro Report). In the Wright-Shapiro Report, Dr. Wright concluded that

> [her] experience in transfer pricing audits around the world is that the questions raised by Dr. Shapiro are not relevant to determining whether a legitimate business purpose existed for the creation of KFR. That said, it is clear that Kellwood had several legitimate business purposes for the creation of KFR, and therefore KFR must be respected.

Expert Testimony Regarding Arm's Length Pricing of Transactions

The Wright Report

189. Kellwood presented the testimony and written report of Dr. Wright to support the arm's length fees charged by KFR to Kellwood for the factoring services. Dr. Wright has a bachelor of science in business with a major in economics from Oklahoma State University and a Ph.D. in economics from Iowa State University.

190. Since earning her doctorate degree in economics, Dr. Wright was an assistant professor of economics at Auburn University from 1973 to 1976. She was then an assistant professor of economics at Southwest Missouri State University from 1976 to 1979 and was promoted to associate professor prior to her departure.

191. Early in her career, Dr. Wright joined the Chicago district office of the Internal Revenue Service as an industry economist where she audited corporations' transfer pricing policies. Transfer pricing refers to the pricing terms for transactions between legal entities within multinational corporation that are governed by IRC § 482.

192. Following her tenure at the Internal Revenue Service, Dr. Wright joined the accounting firm of Coopers & Lybrand where she was charged with developing and managing the transfer pricing practice globally. During her time at Coopers & Lybrand, Dr. Wright performed transfer pricing work for a number of clients in the apparel industry.

193. Dr. Wright left Coopers & Lybrand and became the vice president of Charles River Associates, an economics consulting firm, where she led the transfer pricing practice. During the course of Dr. Wright's career, she has performed work for corporations and the governments of Australia, New Zealand, Malaysia, Canada, Taiwan, as well as for the Internal Revenue Service.

194. Dr. Wright is currently a managing principal of the Analysis Group and has served as the head of the transfer pricing practice since August of 2001. She has almost 30 years of experience working in the transfer pricing field.

195. Dr. Wright speaks frequently on transfer pricing subjects and has written a plethora of articles and two books on transfer pricing, one of which is The U.S. Transfer Pricing Guide. Dr. Wright is currently the chairman of the IBFD Transfer Pricing Advisory Board and also serves on the editorial board of the International Transfer Pricing Journal.

196. Dr. Wright was engaged to determine an arm's length factoring fee for the factoring transactions between KFR and Kellwood that began in January of 2000. Kellwood engaged Dr. Wright when it was audited by New York State to get a second opinion about whether the discount rates that Kellwood used, i.e., the rates recommended by E&Y, were within arm's length ranges. Specifically, Dr. Wright was engaged in February 2005 to prepare "a complete transfer pricing study to develop documentation sufficient to support the discounted price of the accounts receivable that KFR purchases from the operating divisions within the Kellwood group." Dr. Wright prepared a report, entitled "Expert Report of Dr. Deloris R. Wright" and dated May 10, 2006 (the Wright Report).

197. Dr. Wright testified that Kellwood engaged her to determine the arm's length discount rates, not defend the rates already being used. Dr. Wright knew the actual discount rates Kellwood used during the audit period from the beginning of her engagement. Dr. Wright's engagement with Kellwood was the first time she has been engaged to determine arm's length pricing for a factoring transaction between related parties. Dr. Wright testified that she was not an expert in securitization.

198. Dr. Wright was accepted as an expert in economics, transfer pricing and Internal Revenue Code (IRC) § 482.

199. Dr. Wright testified that both of the E&Y reports set forth the proper arm's length transfer price despite the fact that she did not agree with the methodologies used. Dr. Wright opined that the reduction of the discount rate from 3 percent in the first years to 2.4 percent in the remaining years was required because interest rates were dropping generally.

200. In Dr. Wright's opinion, a typical business person would not possess the requisite knowledge of IRC § 482 to see the flaws in the E&Y transfer pricing methodologies employed in the reports.

201. The first step in Dr. Wright's analysis of KFR's purchase of accounts receivable from the various business units was to conduct an industry analysis of both the apparel and factoring industries. An industry analysis is conducted to obtain a better understanding of the industries. Despite Dr. Wright's knowledge about the apparel industry, she conducted additional research and reviewed numerous documents provided by Kellwood.

202. Dr. Wright's industry analysis revealed that factoring is very prevalent in the apparel industry. In 2003, approximately 60 percent of all factoring was done by apparel companies.

203. The second step in Dr. Wright's analysis of KFR's purchase of accounts receivable from various business units was to conduct a functional analysis. As noted previously, as a threshold issue, Dr. Wright examined the transactions and concluded that Kellwood had a business purpose for selling its receivables to KFR and that the transaction had economic substance.

204. In analyzing the business reasons for the transaction, Dr. Wright was not troubled by the fact that Kellwood had not yet entered into an asset-backed securitization transaction because it was clear that Kellwood was seriously considering it.

205. According to Dr. Wright, the business purposes that Kellwood executives articulated for the KFR transaction were consistent with those cited by companies that factor with third parties.

206. As part of her functional analysis, Dr. Wright reviewed all the operative documents and relevant SEC filings, traveled to Kellwood's corporate headquarters, and interviewed executives of KFR and Kellwood to understand the facts surrounding the creation of KFR and KSS and the sale of accounts receivable to KFR. As a result of her functional analysis, Dr. Wright concluded that factoring was a logical extension of Kellwood's process of centralizing some of its back office services such as credit and collection.

207. Based on the facts derived from the functional analysis, Dr. Wright concluded that KFR provided factoring services to Kellwood and must receive arm's length compensation for those services. Dr. Wright then sought to determine whether factoring agreements from closely comparable uncontrolled transactions were available. Dr. Wright examined the functions and risks of an independent factor and compared them to the functions that KFR performed and the risks it assumed. Dr. Wright determined that KFR performed the functions and assumed the risks of an independent factor.

208. The only differences that Dr. Wright noted in comparing KFR to independent factors are that KFR advanced 100 percent of the net receivables and KFR purchased 100 percent of the accounts receivable on a nonrecourse basis. Dr. Wright noted that these differences resulted in

KFR's assuming more risks than an independent factor, which differences would need to be accounted for with adjustments to the discount rate.

209. The third step in Dr. Wright's analysis of KFR's purchase of accounts receivable from the business units was to select the best transfer pricing method under the IRC § 482 regulations. Dr. Wright's functional analysis led her to the conclusion that the comparable uncontrolled price (CUP) method was the best method for determining the arm's length discount rates for the factoring services that KFR provided to Kellwood. Dr. Wright chose the CUP method because she was able to identify comparable transactions, and in cases where comparables are available, the CUP method produces the most reliable result.

210. The fourth step in Dr. Wright's analysis of KFR's purchase of accounts receivable from the business units was to find comparable transactions. Dr. Wright searched for comparable factoring agreements in the Nexis and Thomson One Banker databases and obtained 410 unique agreements, 6 of which fit Dr. Wright's search criteria for a comparable. In Dr. Wright's 30 years of doing transfer pricing analysis, six comparables is a large number of comparables since the IRC § 482 regulations only require one comparable.

211. Dr. Wright eliminated 404 of the 410 factoring agreements obtained in her research for the following reasons:

- Sufficient factoring agreement was not available (eliminated 330 contracts);
- Client company sold nonapparel products (eliminated 55 contracts);
- Factor did not allow the client to advance 100 percent of the purchase price of the nonrecourse receivables, even with a higher penalty interest rate (eliminated 10 contracts);
- Factoring agreement was part of a larger financial contract (eliminated 5 contracts);
- Interest terms were not comparable (eliminated 3 contracts); and
- Factor had recourse on all accounts (eliminated 1 contract).

212. Dr. Wright testified that she evaluated the factoring agreement for each potential comparable to determine whether it had the same characteristics as KFR's factoring agreement with Kellwood including: (l) is the company entering into the factoring agreement an apparel company; (2) did the factor purchase the accounts receivable on a nonrecourse basis; (3) did the factor purchase credit approved accounts receivable; (4) did the factor purchase noncredit approved accounts receivable on a recourse basis; (5) was the factor responsible for collecting the accounts receivable; (6) did the factor have the option to advance 100 percent of the funds; (7) did the factor bear the bad debt expense; (8) was the factor responsible for credit approval; (9) was the factor responsible for credit analysis; and (10) was the factor responsible for maintaining an accounts receivable database.

213. The ten-point selection process noted above is not in the Wright Report as such. A review of the Wright Report reveals, however, that most, if not all, of these points are, either explicitly or implicitly, contained in the report

214. Based on her selection criteria, Dr. Wright concluded that the factoring agreements with Cygne Designs, LBU, Inc., Levcor International, T.K. Mab, Inc., TKC for Kidz, Inc., and Tarrant Apparel Group were comparables because they were substantially similar to the agreement between Kellwood and KFR. According to Dr. Wright, the only significant differences between the agreements are that KFR advances 100 percent of the net receivables and KFR buys risky accounts receivable on a nonrecourse basis while the comparable companies do not.

215. The fifth step in Dr. Wright's analysis of KFR's purchase of accounts receivable from the business units was to make any adjustments required to the comparable transactions

chosen. The IRC § 482 regulations require an adjustment for all differences that have an effect on price. Dr. Wright determined that an adjustment to account for the fact that KFR purchases noncredit-approved accounts on a nonrecourse basis was required.

216. Dr. Wright also made some formatting adjustments, which are calculations designed to put the agreements on the same base. For example, some of the comparable agreements base the factor's commission on gross receivables and some are based on net receivables, so an adjustment must be made so that all the agreements have a common base.

217. Dr. Wright made an adjustment to account for the fact that KFR bought risky receivables on a nonrecourse basis by adding a surcharge to the commission rate. Dr. Wright looked to a third-party contract between DAC Technologies of America, Inc. (DAC) and CIT Group to determine that a one percent surcharge was appropriate for "monitor" accounts and a three percent surcharge was appropriate for "risk" accounts. Dr. Wright found other support for the surcharge from four additional contracts that contained similar surcharges and from an internal Kellwood document which discusses GMAC's attempt to increase its surcharge up to seven percent for Kmart's accounts receivable based on risk.

218. While Dr. Wright made certain adjustments to get to a commission rate component and an interest rate component, she did not make any adjustments for miscellaneous charges. Dr. Wright determined an arm's length commission rate on a stand-alone basis and an arm's length interest charge on a stand-alone basis and then added them together to get one fee which is called the discount rate.

219. Dr. Wright would have made an additional adjustment to account for the fact that Kellwood's terms of sale were greater than 60 days for some of its customers; however, Kellwood did not have the data available that would allow her to reliably compute what the

adjustment should be. Dr. Wright also would have made an additional adjustment to account for the fact that Kellwood was changing the terms of sale with its customers during the years at issue since third party factors would have imposed an additional charge; however, Kellwood did not have the data available to reliably compute what the adjustment should be. If these adjustments were made, the discount rate would have been higher under Dr. Wright's analysis.

220. After calculating each component of the overall arm's length fee, Dr. Wright examined her results to perform what she called a "sanity check." Regarding the commission rate component, Dr. Wright's analysis resulted in adjustments of approximately two-tenths of a percent. Dr. Wright's sanity check of her interest rate calculations similarly demonstrated a small number of adjustments and a small size adjustment (approximately one-half of a percent) which, based on Dr. Wright's extensive experience of doing similar analyses, "gives me a lot of comfort when I'm doing a CUP analysis that I'm getting reliable results."

221. The last step in Dr. Wright's analysis of KFR's purchase of accounts receivable from the business units was to compute an arm's length range of market prices. Consistent with the IRC § 482 regulations, Dr. Wright looked at the interquartile range to determine the appropriate arm's length discount rate, which excludes the top 25 percent and bottom 25 percent of the discount rates. Dr. Wright concluded that the arm's length range of discount rates for the years at issue are as follows: 2.4% to 3.6% in 2000; 2.0% to 3.0% in 2001; 1.7% to 2.6% in 2002; 1.6% to 2.5% in 2003; and 1.6% to 2.5% in 2004.

The Silva Reports

222. The Division retained Dr. Ednaldo Silva to review the E&Y Reports. Dr. Silva prepared two reports entitled "Review of the Ernst & Young 2001 Report," revised February 15,

2007 (the Silva E&Y 2001 Report) and "Review of Ernst & Young 2003 Report," revised February 15, 2007 (the Silva E&Y 2003 Report).

223. The Division also retained Dr. Silva to determine whether the Wright Report established arm's length results for the factoring transactions between Kellwood and KFR. Dr. Silva prepared a report entitled "Review of Dr. Deloris Wright Report," revised February 15, 2007 (the Silva Report).

224. Dr. Silva, who testified at the hearing, holds a PhD in economics from the University of California at Berkeley and is an economist. He was an academic from 1982 through 1990. He worked for the Internal Revenue Service from 1990 through 1993 where he was involved in drafting the IRC § 482 regulations. From 1993 through 2000 he was chief economist for a law firm and in 2000 he started his own business as an economic consultant. Dr. Silva was accepted as an expert in economics and transfer pricing under the IRC § 482 regulations.

225. In the preparation of his reports, Dr. Silva reviewed certain documents provided to him by the Division, which were provided to the Division during and after the audit, and documents from the Securities and Exchange Commission (SEC).

226. In the Silva E&Y 2001 Report, Dr. Silva concluded that "[t]he 3.06% 'total discount' calculated by Ernst & Young is arbitrary and cannot be used to establish an arm's length result to test the intercompany factoring transactions between Kellwood and KFR" for numerous reasons, including E&Y's failure to select a best method or comparables in accordance with the section 482 regulations and its use of unreliable numbers in its calculation of a single factoring discount rate.

227. In the Silva E&Y 2003 Report, Dr. Silva concluded that "the Ernst & Young 2003 report fails to establish that the Kellwood and KFR factoring transactions for the period ending

January 31, 2003 comply with the arm's length standard." Dr. Silva based his conclusion on his determination that E&Y selected a method applicable to transfers of intangible property, even though it characterized the factoring transactions as the provision of intercompany services, and the factoring agreements E&Y selected as comparables do not comply with the standards of comparability in the section 482 regulations. With respect to E&Y's unspecified method, Dr. Silva concluded that E&Y failed to follow the section 482 regulations.

228. Kellwood did not offer the author or authors of the E&Y Reports to testify in their defense at hearing.

229. In the Silva Report Dr. Silva determined that Kellwood's sales of its accounts receivable to KFR differed from Dr. Wright's comparable transactions:

> While all of the Wright agreements are structured similarly to each other, they are substantially different from the KFR agreement. A key difference involves the treatment of commission and interest. In the KFR agreement, KFR purchases receivables at their estimated net value minus a discount. The discount rate incorporates both a commission and an interest component. The factors in the Wright agreements purchase receivables on a non-recourse basis only after providing credit approval, and they pay the purchase price only after receiving payment from the company's customers. If the company requests an advance on the purchase price, the factor may, at is discretion, provide the advance and charge interest.

None of Dr. Wright's comparable transactions express the factor's consideration as a single amount like that of KFR. The factor's consideration is comprised of three amounts: (1) a commission based on net or gross receivables, (2) interest on amounts advanced by the factor, and (3) miscellaneous fees.

230. Before analyzing Dr. Wright's application of the CUP method in the Silva Report Dr. Silva found that the Wright Report failed because Dr. Wright analyzed the factoring transactions for all of Kellwood's business units, not only Kellwood. Dr. Wright used numbers

for the ratio of net receivables to gross receivables, DSO, and monitor and risk accounts in her calculations that included subsidiaries of Kellwood, which could only apply if there were no differences between Kellwood and its subsidiaries. Since this was not true, Dr. Silva determined that the results Dr. Wright obtained cannot establish the arm's length nature of the factoring transactions between Kellwood and KFR.

231. In response to this critique, Dr. Wright noted that she used data relating to Kellwood and its subsidiaries rather than just Kellwood because virtually all of its subsidiaries were also selling their accounts receivable to KFR and, based on her analysis, there was no reason to believe that data including the subsidiaries would be different. Dr. Wright concluded that there were significant similarities between Kellwood and its subsidiaries because they were selling similar products to the same customers, and after the credit and collection function was centralized in the late 1990s, there was a great deal of uniformity of terms across Kellwood's subsidiaries and divisions. Moreover, data did not exist separately for Kellwood and its subsidiaries.

232. With respect to Dr. Wright's CUP analysis, Dr. Silva determined that Dr. Wright used factoring agreements that were not comparable to the agreement between Kellwood and KFR. Recognizing that the CUP method requires a high degree of comparability, Dr. Silva found differences in both economic conditions and contractual terms between Dr. Wright's factoring agreements and the agreement between Kellwood and KFR.

233. Dr. Silva noted that Kellwood was much larger in terms of net sales than the companies in Dr. Wright's factoring agreements. Dr. Silva found a relationship between size of the companies and commission rate, that is, as the size of the companies decreases, the commission rate of the companies increases. Dr. Silva determined that this was a material

difference between the agreement between Kellwood and KFR and Dr. Wright's comparable transactions that affects the commission rates that Dr. Wright did not address in the Wright Report.

234. Dr. Silva found that the companies in four of Dr. Wright's Comparable Transactions, that is, Tarrant Apparel Group, LBU, Inc., T.K. Mab, Inc., and T.L.C. for Kidz, Inc., were in financial distress at the time they entered into their factoring agreements: Dr. Silva noted that "[g]enerally, large companies with stable sales and consistent profits can obtain more favorable terms in financing arrangements than small companies in financial distress" and determined that "Kellwood occupied a much stronger negotiating position due to its size, and its history of operating profits."

235. Dr. Silva also found significant differences between the contractual terms of the factoring agreements Dr. Wright selected in the Wright Report and Kellwood's agreement with KFR. Such differences include the purchase of approved receivables on a nonrecourse basis and nonapproved receivables on a recourse basis in the Wright agreements while KFR purchased all receivables on a nonrecourse basis; KFR's weekly payment of the full purchase price while in the Wright agreements the companies must request advances, which the factor may or may not advance at its discretion; the discount as the sole consideration in the KFR-Kellwood agreement as contrasted with the Wright agreements where consideration consists of commissions, interest on advances and miscellaneous fees; and a lack of a security interest conferred by Kellwood to KFR, while in the Wright agreements, the companies conferred security interests to the factors, which included security interests in the receivable plus other assets of the company.

236. Dr. Silva determined that these differences "do not have a definite and reasonably ascertainable effect on price that would allow for adjustments" and concluded that "[a]s a result,

the CUP method does not produce reliable results in this instance and should not have been selected as the best method."

237. With respect to Dr. Silva's concern regarding the size of the comparables, Dr. Wright was not concerned that the comparables were from companies that were much smaller than Kellwood because the discount rates were very consistent with industry average discount rates. Small comparables are common because the contracts are obtained from SEC filings and companies are only required to submit contracts to the SEC if they are a material part of the business of those companies. In a large company, a single factoring contract would likely not be material so it would not be submitted to the SEC and therefore would not be available to the public. Further, Dr. Wright opined that the proper focus in determining comparability is on the comparability of the accounts receivable and thus on the financial viability of the customers whose receivables are being factored.

238. Dr. Wright also examined the relationship between the discount rate (commission and interest rate) and the total amount of sales for each of the comparables to determine if there was a relationship between the discount rates and the size of the companies. Dr. Wright concluded that there is no clear relationship between net sales and the discount rate; therefore, size is not a factor that would cause either rejection of potentially comparable transactions or adjustments to those transactions.

239. Dr. Wright disagreed with Dr. Silva's critiques regarding her choice of the four comparables based on their economic condition. For the five years 2001-2005, Tarrant only reported losses at the operating profit level in 2004, which largely resulted from labor unrest in Mexico, leading to a decline in revenue from Mexican-produced merchandise. T.K. Mab withdrew an initial public offering three years after the factoring agreement was signed. LBU's

bankruptcy filing occurred in 1999, but the factoring agreement was entered into in 1993. T.L.C. for Kidz entered into a factoring agreement in 1998 when it was owned by Jenna Lane Inc., which reported operating margins of 3.3 percent in that year and 2.9 percent and 2.3 percent in the two subsequent years.

240. Dr. Silva further criticized Dr. Wright's report for accepting the LBU agreement as a comparable because LBU sells bags, promotional materials, and houseware accessories, which Dr. Silva argued were substantially different from the products sold by the business units. In response, Dr. Wright countered that LBU was a comparable because it was designing, manufacturing and selling fashionable bags and promotional products to many of the same customers that Kellwood does and uses many of the same raw materials. Dr. Wright also concluded that LBU was very similar to American Recreational Products, a subsidiary of Kellwood that sold its accounts receivable to KFR.

241. Dr. Silva disagreed with the assumptions and adjustments Dr. Wright made to compute a single discount combining both commission and interest components. One of these assumptions was that the companies in Dr. Wright's factoring agreements would advance 100 percent of the purchase price of the factored receivables. Dr. Silva determined that several of the companies in Dr. Wright's factoring agreements imposed limits on advances or had discretion in making advances. Dr. Silva noted that, without this assumption, Dr. Wright could not compute a single factoring discount rate. Dr. Silva further contends that the one percent and three percent surcharge for the purchase of "monitor" and "risk" accounts is arbitrary and speculative. It is Dr. Silva's opinion that the effect on interest rates of requiring factors to provide advances on Kellwood's "monitor" and "risk" accounts cannot be ascertained.

242. In response to such criticism, the Wright report indicates that Dr. Wright made adjustments to the interest rate component of the discount rate to account for the fact that an independent factor would not advance funds on riskier accounts. All six comparable agreements allow the factor to advance 100 percent of the purchase price. Four of the agreements specify a single interest rate for advances while two of the agreements specify a higher penalty rate for advances beyond the limit. For the two agreements that charge higher interest rates if the factor advances more than the limit, Dr. Wright assessed the specified penalty rates on the amount advanced as required under those contracts. To account for the additional risk of advancing against risky accounts, Dr. Wright then calculated the average penalty premium on the excess from the other two agreements and imposed that penalty interest on Kellwood's percentage of risky accounts for all six comparables to compute the adjusted annual interest rate.

243. Dr. Silva also contended that Dr. Wright did not properly compute the interest component for the discount rate because she did not account for the fact that a business unit's DSO statistic includes the lag time between the time a receivable is generated by a Kellwood business unit and the time the receivable is sold to KFR. Dr. Wright noted that she did not subtract the number of days between the time a receivable is generated by a Kellwood business unit and the time the receivable is sold to KFR (lag days) because there was a corresponding number of lag days between the time the receivables were paid.

244. Dr. Silva further argued that the use of the agreement between DAC and CIT Group was improper because DAC does not operate in the apparel industry and the surcharges apply to both nonrecourse and recourse agreements.

245. Dr. Silva found that "KFR's income statement shows that intercompany factoring transactions yielded extraordinary profits" for KFR:

	FYE 1-31-01	FYE 1-31-02	FYE 1-31-03	3-yr sum/wtd avg
Factoring Income	62,858,147	56,785,500	46,324,497	165,968,144
Bad Debt Exp.	958,866	1,541,594	1,282,562	3,783,022
Other Op. Exp.	2,624,224	2,070,452	3,461,822	8,156,498
Operating Profit	59,275,057	53,173,454	41,580,113	154,028,624
Op. Profit Margin	94.3%	93.6%	89.8%	92.8%

246. Dr. Silva concluded that “the Wright report fails to establish arm’s length dealing between Kellwood and KFR under principles of the § 482 regulations.”

247. In response to the Silva Report, Dr. Wright prepared a report entitled “Review of Expert Report of Ednaldo Silva, Ph.D.,” revised March 15, 2007 (the Wright-Silva Report). In the Wright-Silva Report, Dr. Wright rejected three of Dr. Silva’s opinions and concluded that “the discount rates presented in my Expert Report accurately reflect the fees charged by independent factors.” In addition Dr. Wright asserted that “sensitivity checks” on the assumptions that form the basis of her calculations establish that those assumptions did not have a material effect on her results.

248. Dr. Silva testified that under Treas Reg § 1.482-1(d)(3)(ii)(A)(1) the form of consideration charged or paid is important in analyzing a transaction under the CUP method because the analysis is based upon prices, not any other form of consideration. Sales or purchase volume is also important in a CUP analysis under Treas Reg § 1.482-1(d)(3)(ii)(A)(2) because volume may affect the price of the transaction. The section 482 regulations also contain comparability requirements specific to the CUP method under Treas Reg § 1.482-3 and a discussion that minor differences in contractual terms or economic conditions can produce an unreliable result with regard to the CUP method.

249. In response to Dr. Wright's contention that other methods could not be used to analyze the factoring transaction between Kellwood and KFR, Dr. Silva testified that at least two methods could be used, that is, a method under the comparable profits method or a cost reimbursement plus a markup. An unspecified method using factoring agreements could also be used.

250. Dr. Silva explained that advance limits are important because, if Dr. Wright had not made the assumption that the companies in her factoring agreement made 100 percent advances, Dr. Wright could not have added the commission rate and the interest component together in obtaining a single discount rate. This is because the commission rate base is the net face value of the receivables while the interest rate base is the amount advanced. If these two components were not equal Dr. Wright could not have combined them.

251. In response to Dr. Wright's contention that she used the best data available in her analysis, Dr. Silva testified that he would have expected her to use numbers that most closely reflected those of Kellwood, not rely on numbers that reflected entities other than Kellwood and KFR. According to Dr. Silva, using information for the parties involved in the transaction is important not only for the CUP method but for all methods under the 482 regulations because it is only those parties that are being combined for state tax purposes or adjusted for federal tax purposes.

252. Dr. Silva testified that:

> [i]f commission rate is influenced by size, such that large companies have a lower commission rate than smaller companies, one has to do either one of two things: either create two groups, the group that corresponds in size to the company being tested, in this case, Kellwood, and use the commission rates or the range of commission rates of comparable companies. Or one would make an adjustment for size to reflect the fact that the size of the company is influencing the commission rate.

253. Regarding the question of a relationship between sales and commission rates as raised in the Silva Report and responded to in the Wright-Silva Report, the following data compares the net sales of companies in Dr. Wright's comparable transactions with their adjusted discount rates:

Average Adjusted Discount Rate Descending Rank[2]	Company	Net Sales[3]	**Net Sales** Ascending Rank[4]
	Kellwood	$979,230,9224[5]	
5	Tarrant Apparel Group	$151,452,663	1
3	Cygne Designs, Inc.	$24,019,000	2
4	Levcor International, Inc.	$10,134,755	3
6	T.L.C. for Kidz, Inc.	$7,100,000	4
1	T.K. Mab, Inc.	$2,106,930	5
2	LBU, Inc.	$1,779,441	6

254. Dr. Silva responded to Dr. Wright's claim that his analysis of commission rate and net sales was flawed by analyzing the total fee, that is, the commission rate, the interest rate, and miscellaneous fee, with net sales. Dr. Silva concluded: (1) there is a relationship between commission rate and size; (2) there is a relationship between Dr. Wright's adjusted discount rate and size; and (3) Dr. Wright's results are dependent upon two agreements, that is, LBU and T.K. Mab, and if removed, Kellwood's discount rate falls outside the range of Dr. Wright's results. LBU's adjusted discount rates ranged between 2.61 percent and 3.59 percent

[2] "1" represents the largest rate; "6" represents the smallest rate.

[3] Net sales of companies in Dr. Wright's comparable transactions from the Wright-Silva Report.

[4] "1" represents the largest net sales; "6" represents the smallest net sales.

[5] Net sales of Kellwood (without its subsidiaries) from the Silva Report.

during the audit period and its adjusted commission rates ranged between 1.39 percent and 1.40 percent. T.K. Mab's adjusted discount rates ranged between 2.96 percent and 3.95 percent during the audit period and its adjusted commission rates ranged between 1.66 percent and 1.68 percent.

255. In response to Dr. Wright's contention that Dr. Silva assumes that independent factors do not make advances when "in practice" independent factors do make advances (even though given discretion), Dr. Silva testified that none of Dr. Wright's factoring agreements provide for 100 percent advances.

256. With respect to Dr. Wright's adjustment for risk and monitor accounts, Dr. Silva testified that Dr. Wright based the adjustment on information not found in Dr. Wright's factoring agreements, supported it with an agreement she rejected as a possible comparable agreement (the DAC contract), and disregarded specific facts of that agreement by applying it to all receivables, not only those receivables that extend beyond the terms of sale or are DIP or foreign sales.

257. Dr. Silva testified that Dr. Wright's "sanity checks" with respect to each of her adjustments do not take into account the cumulative effect of all of her adjustments on her results.

258. Dr. Silva testified that none of Dr. Wright's comparable transactions, or any that Dr. Silva reviewed, combine the commission rate with the interest rate. These considerations cannot be combined because the commission rate is a fixed component while the interest rate is a variable component. In her analysis, Dr. Wright "fixed" the interest component by using a fixed number for DSO. In Dr. Silva's opinion, Dr. Wright should not have used a fixed DSO because interest is calculated on the actual number of days elapsed between invoice and payment in Dr.

Wright's comparable transactions. Therefore, any fluctuation in DSO or interest rate adjustment is not reflected in her calculation of a single discount rate.

259. Dr. Wright testified that in the factoring industry, the interest rate ordinarily represents the largest part of the discount rate. Dr. Wright's adjusted commission rate is less than the adjusted interest rate for each of Dr. Wright's comparable transactions.

260. Dr. Silva also testified about the reasons he looked at the financial results of KFR in the Silva Report. Dr. Silva opined that had Dr. Wright looked at the financial results of Kellwood and KFR, as instructed by the Internal Revenue Manual and suggested by the Internal Revenue Service, she would have realized that her use of the CUP method produced disparate results, that is, low operating profit in the company selling its receivables (Kellwood) and high profit in the company purchasing the receivables (KFR). In Dr. Silva's opinion, Dr. Wright cannot determine an arm's length rate without looking at the financial results of Kellwood and KFR or explaining the disparity in the results. Dr. Silva testified that, using the Compustat database, he looked at all of the listed companies in the United States and did not find a company with an operating profit similar to KFR's operating profit.

261. Dr. Silva did not conduct his own study to determine the proper discount rate for the years at issue.

262. Kellwood submitted proposed findings of fact numbered 1-160. These proposed findings are accepted and have been incorporated in these Findings of Fact with the following exceptions: proposed findings of fact 20, 22, 23, 26, 42, 52, 57, 60, 73, 74, 81, 82, 83, 88, 90, 103, 107, and 134 have been modified to better reflect the record.

263. The Division submitted proposed findings of fact numbered 1-165. These proposed findings are accepted and have been incorporated in these Findings of Fact with the following

exceptions: proposed findings of fact 49, 68, 112, 128, 151,158, and 159 have been modified to better reflect the record; proposed findings of fact 79 and 100 are rejected as irrelevant.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law § 209[1]). In order to properly reflect a taxpayer's franchise tax liability under Article 9-A, Tax Law § 211(4) provides, in relevant part, as follows:

> (a) Combined reports permitted or required. In the discretion of the commissioner, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such information as the commissioner may require, subject to the provisions of paragraphs one through five of this subdivision.

The statute limits the discretion afforded the Division with respect to nontaxpayer corporations as follows:

> No combined report covering any corporation not a taxpayer shall be required unless the commissioner deems such a report necessary, because of intercompany transactions or some agreement, understanding or arrangement or transaction referred to in subdivision five of this section, in order to properly reflect tax liability under this article. (Tax Law § 211[4][a][4].)

Subdivision 5 (Tax Law § 211[5]), noted above, refers to "any agreement, understanding or arrangement . . . between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected."

B. The Division's regulations interpreting the foregoing provisions provide that a group of corporations may be required or permitted to file a combined report where three conditions are met:

> (1) the taxpayer corporation owns or controls at least 80 percent of the voting stock of the other corporations which are to be included in the combined report (ownership test) (20 NYCRR 6-2.1[a][1], 6-2.2[a]);
>
> (2) the group of corporations is engaged in a unitary business (unitary business test) (20 NYCRR 6-2.1[a][2], 6-2.2[b]); and
>
> (3) reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers (distortion of income test) (20 NYCRR 6-2.1[a][3], 6-2.3[a]) .

Distortion will be presumed to exist if there are substantial intercorporate transactions among the corporations in the proposed combined group (20 NYCRR 6-2.3[a]). Substantial intercorporate transactions are found where "as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities . . ." (20 NYCRR 6-2.3[c]).

C. In the present matter, the first two conditions for permitting or requiring combined filing are met. Specifically, there is no dispute that Kellwood owns 100 percent of the stock of KFR and KSS and that Kellwood, KFR and KSS were engaged in a unitary business. Furthermore, Kellwood concedes that the transactions between KFR and it and KSS and it were substantial intercorporate transactions within the meaning of the regulations. This fact gives rise to a rebuttable presumption of distortion (***see Matter of Hallmark Marketing Corp***., Tax Appeals Tribunal, July 19, 2007).

D. Kellwood's rebuttal of the presumption of distortion is a question of fact (***Matter of Sherwin-Williams Co.***, Tax Appeal Tribunal, June 5, 2003, ***confirmed Sherwin-Williams Co. v. Tax Appeals Tribunal***,12 AD3d 112, 784 NYS2d 178, [2004], ***lv denied,*** 4 NY3d 709, 797 NYS2d 421 [2005]). Where, as in the present matter, the Division has challenged the business

purpose and economic substance of the subject intercompany transactions, a petitioner's rebuttal of the presumption of distortion must begin with a refutation of such challenge (***see Sherwin-Williams Co. v. Tax Appeals Tribunal***, ***supra***,12 AD3d 112, 118, 784 NYS2d 178, 184 ["The Tribunal's determination that petitioner failed to rebut the presumption of distortion since the [intercompany transactions] lacked a business purpose or economic substance apart from tax avoidance is supported by substantial evidence."]) Kellwood's case fails if it does not establish a business purpose and economic substance for the transactions (***id***. ["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 [intercompany transactions] reflected market rates."]).

E. If Kellwood prevails on the questions of business purpose and economic substance, it must then show that the intercorporate transactions which give rise to the presumption of distortion are arm's length and thereby establish that separate reporting properly reflects its income (***see Matter of Silver King Broadcasting of N.J.***, Tax Appeals Tribunal, May 9, 1996). Regulations under section 482 of the Internal Revenue Service may be used to establish the arm's length nature of the subject intercompany transactions (***see Matter of Hallmark Marketing Corporation***, ***supra***). If Kellwood successfully rebuts the presumption of distortion the burden shifts to the Division to show why reporting on a separate basis does not properly reflect income (***see***, ***Matter of Silver King Broadcasting of N.J.***, ***supra***).

F. The Division asserts that the transactions between Kellwood, KFR and KSS lack economic substance and were not accomplished for a substantial business purpose. As noted, such a finding would mean a failure to rebut the presumption of distortion under ***Sherwin-Williams Co. v. Tax Appeals Tribunal (supra)*** and would permit the forced combination sought

by the Division herein. Kellwood contends that it has established that the transactions did have economic substance and were accomplished for a business purpose.

Preliminarily, any discussion of economic substance and business purpose must begin by noting the well-established "legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits" (***Gregory v. Helvering***, 293 US 465, 469 [1935]). Economic substance doctrine serves as a check on abuses of this principle by denying a taxpayer "tax benefits from a transaction that lacks economic reality" (***Coltec Industries v. U.S.***, 454 F3d 1340, 1355 [Fed Cir 2006]).

In ***Matter of Sherwin-Williams Co.*** the Tax Appeals Tribunal addressed the issue of whether, in the context of a proposed forced combination, transactions between controlled corporations had economic substance and therefore should be respected. In reaching its conclusion in that matter, the Tribunal relied on the Supreme Court's decision in ***Frank Lyon Co. v. United States*** (435 US 561, 583-584 [1978]), which held:

> [W]here . . . there is a genuine multiple-part transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax - avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

In ***Sherwin-Williams*** the Tribunal noted that the question of economic substance is properly analyzed by the two-prong test enunciated in ***Rice's Toyota World v. Commissioner***, (752 F2d 89 [4th Cir 1985]). The Fourth Circuit found that this test "properly gives effect to the mandate of the Court in ***Frank Lyon***" (***id***., at 92).

The Tribunal summarized the two-prong test in ***Sherwin-Williams*** as follows:

> The first prong is to establish whether the transactions were accomplished for a valid business purpose. The second prong of the test is to determine whether the transaction had economic substance. "The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction" while the

> economic substance inquiry "requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits" (***Rice's Toyota World v. Commissioner***, ***supra***, 752 F2d at 92, 94).

G. Turning first to the objective economic substance prong, Kellwood contends that the profit potential standard of ***Rice's Toyota World*** is not properly applicable herein because, although the Tribunal quoted the ***Rice's Toyota World*** test in its ***Sherwin-Williams*** decision, it did not employ that test in its analysis. Kellwood correctly notes that various courts throughout the country have developed different interpretations of the meaning of "economic substance" under the general principles of the ***Frank Lyon*** standard. For example, some courts have focused on the "economic effects" of the transaction, finding that "the creation of genuine obligations enforceable by an unrelated third party" to be a sufficient economic effect to satisfy the economic substance requirement (***see United Parcel Service v. Commr***, 254 F3d 1014, 1018 [11th Cir 2001]; ***see also Kirchmann v. Commr***. 862 F2d 1486 [11th Cir 1989]). The Ninth Circuit has stated that the economic substance factor involves a consideration of "whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction" (***Bail Bonds v. Commr***, 820 F2d 1543, 1549 [9th Cir 1987]). Still other courts have articulated the economic substance inquiry as "whether the transaction affected the taxpayer's position in any way" outside of tax consequences (***see In re CM Holdings, Inc***., 301 F3d 96, 103 [3rd Cir 2002]).[6]

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[6] Kellwood cited two other cases in support of its proposition that, in order satisfy the economic substance prong, the economic benefit of a transaction need not be quantified in terms of a profit. ***Northern Indiana Public Service Co. v. Commr***, 115 F3d 506 [7th Cir 1997]) addressed the question of whether a subsidiary corporation's transactions with third parties should be respected or whether the tax consequences of such transactions should be attributed to the parent. The court's analysis in that case addressed whether the subsidiary should be disregarded for Federal tax purposes under ***Moline Properties v. Commr***, (319 US 436), and its progeny. The instant matter does not involve whether KFR and KSS should be recognized but whether transactions between Kellwood and KFR have economic substance. As the Division correctly notes in its brief, these are separate issues (***see Black and Decker Corp. v. U.S.***., 436 F 3d 431, 441-442). Petitioner also cited ***Cottage Savings Assn v. Commr***, (499 US 554). In that case, the Court, apparently frustrated by a lack of explication of the Commissioner's position that certain losses lacked economic substance, found in favor of the taxpayer given the lack of any contention that the subject transactions were not conducted at arm's length or that the taxpayer retained any de facto interests following the

Kellwood suggests that the Tribunal in ***Sherwin-Williams*** used an economic effects and economic benefits approach, "analyzing the transaction to see if a meaningful change that benefitted the taxpayer resulted from the transaction at issue."[7]

Matter of Sherwin-Williams (supra) involved a transfer of trademarks to two wholly-owned subsidiaries in exchange for all of the common stock of the subsidiaries. The subsidiaries then licensed the trademarks back to the parent in exchange for royalty payments based on a percentage of sales. As noted, the Tribunal cited the two-prong test of ***Rice's Toyota World*** based on the principles of ***Frank Lyon*** as the standard to determine whether transactions between controlled corporations should be respected. The Tribunal examined in detail the stated objectives for the formation of the subsidiaries and the actual activities of the subsidiaries following their formation. This examination revealed that the subsidiaries were empty shells devoid of substance. The Tribunal found that many of the stated objectives were unattainable, illogical or not pursued. With respect to operations, the Tribunal found that the functions for which the subsidiaries were created were being performed by the corporate parent and that although the subsidiaries were given broad authority over the trademarks, the part-time employee ostensibly hired to run both subsidiaries lacked any relevant experience for his job and had little knowledge of the trademarks themselves. The other officers of the subsidiaries also lacked any experience with trademarks. Additionally, the employee had very limited check-signing authority. The Tribunal noted that "the functions of Sherwin-Williams have not changed after the transactions creating the assignment and lease-back of the Marks" and concluded that "the

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transactions (***see id*** at 568). These two cases are thus inapposite to the instant matter.

[7] In its brief Kellwood improperly cites certain Division of Tax Appeals administrative law judge determinations as consistent with the Tribunal's analysis in ***Sherwin-Williams*** in support of its position. Pursuant to Tax Law § 2010(5) such determinations "shall not be cited , shall not be considered as precedent nor given any force or effect in any other proceedings."

form of this transaction does not match its substance." The Tribunal found that the transfer and lease-back of the trademarks was "inherently illogical and not rational from a business or economic standpoint" and that, other than tax avoidance, "there was not any economic benefit to be derived." In its analysis of the economic substance prong, the Tribunal observed that the only benefit to petitioner arising from the transactions was tax avoidance: "There has been no other non-tax benefit realized." The Tribunal also found a lack of economic substance "since many of the objectives in the business plan were wholly unattainable, the evidence failed to establish the pursuit of any of the proposed business plans following the creation of [the subsidiaries] and there was not any economic benefit to be derived."

H. Kellwood's contention that the profit potential test of ***Rice's Toyota World*** is not the proper standard to determine economic substance under the principles of ***Frank Lyon*** is rejected. As noted, the Tribunal plainly stated in ***Sherwin-Williams*** that "the economic substance inquiry 'requires an objective determination of *whether a reasonable possibility of profit from the transaction existed* apart from tax benefits' (citation omitted)" (emphasis added). Petitioner contends that had the Tribunal applied the profit potential test in ***Sherwin-Williams*** there would have been a discussion of the costs that Sherwin-Williams bore and the resulting profits or lack thereof. The facts of ***Sherwin-Williams***, however, made such a discussion unnecessary. As noted, the Tribunal's analysis of the facts revealed the formation of the subsidiaries to be "inherently illogical" and their function was performed by their parent. The Tribunal thus found a lack of any nontax benefits. Given such facts it is hardly surprising that the Tribunal did not delve into a dollar-for-dollar analysis of costs and benefits since questions about profit potential were answered by the revelation that the subsidiaries were empty shells.

That the economic substance standard of ***Rice's Toyota World*** is the proper standard herein is further supported by the Tribunal's subsequent use of the same test in ***Matter of Premier National Bancorp, Inc***. (Tax Appeals Tribunal, August 2, 2007) to determine whether certain transactions had a business purpose and economic substance. Contrary to Kellwood's contention, the significance of ***Premier National Bancorp*** is not diminished by the fact that that case involved the franchise tax on banking corporations under Article 32 of the Tax Law. The economic substance doctrine has been developed by the courts in innumerable federal income tax cases for more than 70 years and is premised on the fundamental notion that tax liability depends upon the substance and not the form of a transaction (***see e.g***. ***Gregory v. Helvering***, ***supra***). Accordingly, there should be no distinction or differing standard in its application under Article 32 or Article 9-A.

Finally, it is noted that, in addition to its application in ***Rice's Toyota World***, the profit potential standard is a well-established interpretation of the economic substance test. (***See e.g. Black & Decker Corp. v. U.S.***, 436 F3d 431, 441, 442 [4th Cir 2006]; ***Coltec Industries, Inc. v. U.S.***, 454 F3d 1340, 1356 [Fed Cir. 2006]; ***Gilman v. Commr***, 933 F2d 143, 147 [2nd Cir 1991]; ***Long Term Capital Holdings v. U.S.***, 330 F Supp 2d 122, 172 [D Conn 2004], ***affd*** 150 F Appx 40 [2d Cir 2005].)

I. Turning to the application of the economic substance prong in this matter, in order to determine whether Kellwood has satisfied this part of the test, it is necessary to examine in detail the transactions that give rise to the claim of distortion (***see Matter of Sherwin-Williams***, ***supra*** ["[T]he *transactions* (i.e., the transfer and license-back of trademarks) were inherently illogical and irrational from a business or economic standpoint."; emphasis added]; ***see also Rice's Toyota World v. Comm'r***, ***supra*** ["[T]he economic substance inquiry requires an objective

determination of whether a reasonable possibility of profit from the *transaction* existed apart from tax benefits."; emphasis added]; ***Black & Decker Corp. v Commr***, ***supra***, 436 F3d 431, 441). Accordingly, it is necessary to examine the transactions between Kellwood and KFR.

It is not a question, therefore, of whether the entities themselves, i.e., KFR and KSS, had economic substance. In this respect, KFR and KSS differ sharply from the subsidiaries in ***Sherwin-Williams***. As noted, the subsidiaries in that case were mere shells. Here, in contrast, KFR and KSS were active corporations employing real employees who provided real credit and collections services to Kellwood.

The transactions at issue are the transfers of accounts receivable from Kellwood to KFR pursuant to the agreement of January 31, 2000 (***see*** Finding of Fact 102). Under that agreement, Kellwood transferred its net receivables to KFR in exchange for (1) the servicing of those receivables by KFR and (2) the advancement of 100 percent of the face value of the receivables less the discount rate. The discount rate was the consideration paid by Kellwood to KFR under the agreement. As computed by E&Y the discount rate in effect for the fiscal years ended January 31, 2000 through January 31, 2002 was the sum of a fixed fee of .89 percent, collection expense of .10 percent, bad debt of .24 percent and time value of money of 1.83 percent (***see*** Finding of Fact 125).[8] The fixed fee, collection expense and bad debt components of the discount rate compensated KFR for the servicing of the receivables and the risk of nonpayment. The time value of money component compensated KFR for the advances prior to actual payment by the customer. Hence, about 60 percent of the amounts paid by petitioner to KFR during these three fiscal years (1.83 percent ÷ 3.06 percent = 59.80 percent) was attributable to the advances of the accounts receivable. With respect to the fiscal year ended January 31, 2003, the discount

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[8] The sum of these components of the discount rate is 3.06 percent. The actual discount rate was modified to 3 percent "for ease of administration and to be conservative" (***see*** Finding of Fact 125).

rate was reduced by about .6 percent to 2.41 percent. The time value of money component was reduced only by about .1 percent to 1.695 percent (***see*** Finding of Fact 128). Thus about 70 percent of the payments to KFR for that year (1.695 percent ÷ 2.41 percent = 70.33 percent) were for financing.

Kellwood paid KFR $62,858,147, $56,785,500, and $46,324,497 under the agreement for the fiscal years ended January 31, 2001, January 31, 2002, and January 31, 2003, respectively (***see*** Finding of Fact 14). Of those amounts, based on the allocations made in the E&Y reports, approximately $37,589,000, $33,958,000, and $32,580,000 is attributable to the time value of money component of the discount rate, i.e., the advances of the accounts receivable, for the fiscal years ended January 31, 2001-2003, respectively. In total for those three years, then, about $104 million of the approximately $166 million Kellwoood paid to KFR was for financing, with the balance of about $62 million for credit and collections services.

J. As noted, the economic substance prong requires an examination of whether "a reasonable possibility of profit existed from the transactions apart from tax benefits"(***Rice's Toyota World v. Commr***., ***supra***). Stated somewhat differently, this doctrine examines whether the taxpayer "purposefully incurred expense in excess of any reasonably expected gain" (***Long Term Capital Holdings v. U.S.***, 330 F Supp 2d 122, 186 [D Conn 2004], ***affd*** 150 F Appx 40 [2nd Cir 2005]). The analysis is viewed from the "standpoint of a prudent investor" (***Gilman v. CIR***, 933 F2d 143, 147 [2nd Cir 1991]) at the time the transactions are contemplated (***ACM Partnership v. Commr***, 157 F 3d 231, 257 [3rd Cir 1998], ***cert. denied***, 526 US 1017 [1999]).

Here, at the time Kellwood entered into the transactions with KFR it could reasonably estimate the cost of the arrangement, as the price was set at 3 percent of net receivables. On the benefits side, Kellwood had the October 23, 1998 Price Waterhouse report which estimated

savings of $1,262,000.00 annually from the centralization of the credit and collections function of Kellwood and its subsidiaries in the shared services division (***see*** Finding of Fact 66). Such savings would thus have been available even without the creation of KFR and the sale of receivables to KFR.

Kellwood performed no other analysis of anticipated savings to be gained from the KFR transactions.

Petitioner has failed to show that it reasonably anticipated any economic benefit from the financing component of the transaction. As noted, about 60 percent of the consideration paid by Kellwood to KFR was for advances of the accounts receivable. There is no evidence in the record, however, that Kellwood even considered any economic benefit from this component, notwithstanding that most of the consideration paid under the agreement was attributable to the advances.

Specifically, petitioner articulated centralization of credit and collections and positioning itself to engage in an asset-backed securitization, in addition to tax savings, as its purposes in forming KFR and entering into the accounts receivable transactions. Petitioner has not, at any time, stated that access to the short-term financing afforded by the advances was a purpose of the transactions. Nevertheless, petitioner structured an agreement which required financing (***see*** Finding of Fact 103)[9] and in which about 60 percent of the consideration is attributable to financing costs.

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[9] This feature of the KFR agreement, which required KFR to advance 100 percent of the net receivables differs significantly from the third-party factoring contracts asserted by petitioner to be comparable to the KFR agreement. None of these contracts require the factor to advance funds. Instead, the factor advances funds only upon the company's request (***see*** Findings of Fact 229 and 235). This mandatory advance feature, coupled with the absence of any need or benefit from the advances as discussed herein, strongly suggests that the time value of money component of the discount rate had as its purpose tax savings and little else.

The record shows that Kellwood was actively engaged in obtaining financing both prior to and during the period at issue. Access to financing sufficient to meet Kellwood's needs was unquestionably an important part of petitioner's business during the years at issue. Petitioner's credit facility was generally sufficient to meet its needs, but petitioner foresaw the need for financing in excess of the amount available through the credit facility and explored the possibility of an asset-backed securitization as an additional source of financing if necessary. There is no evidence in the record, however, that petitioner ever considered the "financing" that was part of the KFR deal to be any sort of a solution to its financing problems.

The fact that Kellwood did not consider its factoring agreement with KFR as a solution to its financing problems shows that such an arrangement, that is, a true factoring agreement, was not suitable for Kellwood. As noted in the record, access to working capital through advances of the receivables is one of two reasons why companies enter into factoring agreements (***see*** Finding of Fact 44).[10] The cost of financing such advances usually accounts for the largest part of the consideration paid to a factor (***id.***). Moreover, the cost of financing via a typical factoring agreement is generally higher than the cost of other kinds of financing, such as Kellwood's revolving credit facilities (***id.***). Thus companies with limited access to other forms of financing tend to turn to factoring as a source of financing (***see*** Finding of Fact 170). Kellwood was not such a company as it generally had access to sufficient (and less costly) financing through its credit facility. Moreover, Kellwood clearly preferred securitization as a more viable backup to its normal credit facility borrowings, as it actively pursued such alternate financing. Kellwood's view of factoring as a costly and thus inferior form of financing is evidenced by its decision to

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[10] The other reason is the outsourcing of credit and collections (***see*** Finding of Fact 41).

terminate the third-party factoring agreement of its newly-acquired subsidiary, Koret, because cheaper funds were available through Kellwod's credit facility (***see*** Finding of Fact 146). The high cost of factoring is also shown in an executive summary of Kellwood's credit and collections planning for the 2003 fiscal year, which reported that Kellwood realized substantial savings as a result of the elimination of third-party factors at six business units (***see*** Finding of Fact 146). Additionally, Kellwood's entry into a factoring agreement with KFR, given the high cost of factoring, is inconsistent with Kellwood's stated goal of lowering administrative costs via centralization (***see*** Finding of Fact 88[6]) and runs contrary to one of the stated benefits of shared services, i.e., the elimination of factor fees (***see*** Finding of Fact 65).

Kellwood appropriately did not see the agreement with KFR as a source of financing because the advances made under the agreement were not in any economic sense a source of financing for Kellwood. At the time the receivables were first transferred to KFR under the agreement, KFR did not have the money to purchase the receivables and to make advances to Kellwood. Consequently, Kellwood loaned the money to KFR to make the purchases. The proceeds of such loans were the source of the advances from KFR to Kellwood. This circular flow of money had little effect on Kellwood's net economic position and, according to Dr. Shapiro, such advances were not a source of financing for Kellwood (***see*** Finding of Fact 187). Even after KFR became a net lender to Kellwood, its advances to Kellwood were not a true source of financing because the source of the advanced funds were Kellwood's own receivables, which it would have had absent the interposition of KFR and the factoring agreement. Thus, according to Dr. Shapiro KFR was never a source of net new financing to Kellwood (***id***.).

Kellwood has also failed to show that it reasonably anticipated any economic benefit in the creation of KFR and the KFR transactions in connection with its pursuit of asset-backed

securitization. Such a securitization would have required transferring title to receivables to a bankruptcy-remote entity (***see*** Finding of Fact 71). Kellwood management was aware that KFR was not and could not be a bankruptcy-remote entity (***see*** Finding of Fact 162). Hence the creation of KFR and the transfer of receivables to KFR was not a necessary step in implementing an asset-backed securitization. Furthermore, Kellwood has not presented evidence to show that the creation of KFR and the transfer of receivables to KFR was a normal or customary intermediate step in the creation of a securitization facility, or that such transactions would lower the cost of a securitization. Kellwood did assert that the centralization of credit and collections through the creation of KFR and the transfer of receivables to KFR improved the quality of the receivables and thereby facilitated a possible future securitization. If true, this would constitute an economic benefit to Kellwood. While Mr. Hummel testified that he “didn’t think” that Kellwood’s receivables were of sufficient quality to enter into a securitization transaction in August 1999, his testimony is uncorroborated by any other evidence in the record (notwithstanding evidence of extensive contacts with banks regarding securitization), and is in fact inconsistent with Kellwood’s active pursuit of securitization in the late1990s, prior to the creation of KFR (***see*** Findings of Fact 70-74). Accordingly, this assertion is rejected.

In contrast to its limited examination of the nontax benefits, Kellwood did analyze in some detail the potential tax savings to be gained from the KFR transactions (***see*** Findings of Fact 75-77, 81, 83, 90, 91). Among other points of such analysis, E&Y’s initial proposal to Kellwood for the formation of a factoring company estimates annual tax benefits of $900,000 to $1,300,000. E&Y also identified states where Kellwood’s tax savings would be most significant. The primacy of tax savings as Kellwood’s rationale for entering into the KFR transactions is also evidenced by the structure of E&Y’s compensation (***see*** Finding of Fact 95).

As the foregoing discussion makes clear, although Kellwood was aware of the costs of the transactions and considered the benefits from the centralization component of the transactions, it did not consider the benefits to be gained from the financing component of the transactions. Considering that the financing component comprised 60 percent of the consideration paid, this failure evinces a "lack of regard" for the benefits to be gained from this "essential component" of the KFR transactions and Kellwood's failure to analyze such benefits at the time it entered into the transactions supports a conclusion that the transactions were "not designed or reasonably anticipated to yield" benefits commensurate with their costs (***ACM Partnership v. Commr***, ***supra***, 157 F 3d 231, 257). Moreover, it is significant that the financing component served "no non-tax business purpose" (***id***.), that the terms of the financing component are atypical of third-party factoring agreements, and that petitioner derived no benefit from this 60 percent of the consideration. The financing component thus appears designed solely to increase tax benefits. Additionally, petitioner failed to show any anticipated (or actual) economic benefit from the transactions in connection with the potential asset-backed securitization. It is concluded therefore that a prudent investor would not have entered into the KFR transactions as the cost of such transactions greatly exceeded any reasonably anticipated benefits (see ***Gilman v. CIR***, ***supra***, 933 F2d 143, 147; ***Rice's Toyota World v. Commr***., ***supra***; ***Long Term Capital Holdings v. U.S.***, ***supra***, 330 F Supp 2d 122, 186). Accordingly, petitioner has failed to show that the KFR transactions had economic substance.

K. Even an after-the-fact consideration of the actual benefits gained by Kellwood from the transactions (contrary to ***ACM Partnership v. Commr***, ***supra***, 157 F 3d 231, 257) compels the same result. Kellwood has shown that it derived at most about $20 million in annual savings, apparently unanticipated, from the centralization of its credit and collections functions through

shared services and later KFR and KSS. Specifically, a fiscal year 2002 report indicates a savings of about $2.8 million annually in company-wide credit and collection expenses, a $1.2 million annual reduction in interest expense, and a freeing up of approximately $15 million in cash (***see*** Finding of Fact 145). The record also shows that a net decrease in employees in credit and collections saved Kellwood about $1 million (***see*** Finding of Fact 143).[11] While such savings are not insignificant, from the standpoint of a prudent investor, and in the absence of any other nontax benefits, they clearly do not justify an average annual expense in excess of $50 million (***see*** Conclusion of Law I).

L. Turning to the subjective business purpose prong of the economic substance doctrine,[12] as enunciated in ***Rice's Toyota World***, the question of business purpose concerns "the motives of the taxpayer in entering the transaction" (752 F2d at 92). As noted, Kellwood has articulated two non-tax business purposes for the KFR transaction: centralization of credit and collections and positioning itself to engage in an asset-backed securitization. Pursuant to the following discussion, however, Kellwood has failed to establish that either of these purposes constituted a valid business purpose for the subject transactions.

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[11] On the point of savings from centralization it is noted that Mr. Hummel testified that as a result of the centralization Kellwood saved about $40 million in cash made available by reducing days sales outstanding and about $75 million in savings in inventory reductions over a three or four year period (***see*** Findings of Fact 139 and 140). Lacking documentary support, however, this testimony is rejected. Indeed, the tentative nature of Mr. Hummel's estimate regarding savings resulting from reducing DSOs is shown by his lack of knowledge, even after the fact, as to whether the savings from reducing DSOs was less than the cost of the factoring agreement with KFR (***see*** Finding of Fact 152).

[12] It is noted that the economic substance test as set forth in ***Rice's Toyota World (supra),*** and followed in ***Matter of Sherwin-Williams (supra),*** and ***Matter of Premier National Bancorp, Inc. (supra)***, appears to require a taxpayer to satisfy both prongs of the test in order to prevail. In the absence of any definitive authority from the Tribunal on this specific point, however, this determination will also address the business purpose prong of the test.

Regarding the securitization motive, as discussed previously, petitioner has failed to show any link between its efforts to implement a securitization facility and the KFR transactions. As Kellwood was aware, an asset-backed securitization required a bankruptcy-remote entity. As Kellwood was also aware, KFR was not a bankruptcy-remote entity and therefore could not be used as the special purpose entity required in a securitization. Additionally, Kellwood has not shown that the creation of an intermediate entity like KFR was a normal or customary step in the process of a securitization or that the creation and transfers to KFR would provide Kellwood with any cost savings in its pursuit of securitization. As also discussed previously, Kellwood has failed to prove that the centralization of credit and collections was necessary to improve the quality of the receivables and thereby facilitate a possible future securitization. Accordingly, securitization fails as a valid business purpose for the KFR transactions.

Regarding centralization of credit and collections, Kellwood began to centralize its credit and collections function under the shared services division in the late 1990s and later under KFR and KSS. There is no question that Kellwood had a valid business purpose in centralizing this function. The question, however, is not whether Kellwood had a valid business purpose in forming KFR and KSS. The question is whether the transactions between Kellwood and KFR had a valid business purpose. Those transactions, as structured by Kellwood, were principally concerned with the payment of financing costs by Kellwood. As discussed, Kellwood did not want, need or benefit from such financing, yet it structured a transaction pursuant to which 60 percent of the consideration was attributable to such financing. If Kellwood's motivation in entering the KFR transactions was the centralization of credit and collections the consideration paid under the agreement would have reflected such motivation. Accordingly, credit and collection also fails as a business purpose for the subject transactions.

M. As this determination has concluded that the transactions at issue lacked economic substance and a nontax business purpose, it is not necessary to address the separate ground of whether the subject transactions reflected arm's length prices pursuant to Internal Revenue Code section 482 regulations (***see Matter of Sherwin-Williams Co. v. Tax Appeals Tribunal***, ***supra***,12 AD3d 112, 784 NYS2d 178, 184).

N. The Division has asserted penalty for substantial understatement of tax due pursuant to Tax Law § 1085(k). Such penalty may be waived if the taxpayer establishes reasonable cause for the understatement and that it acted in good faith (Tax Law § 1085[k]). Here, Kellwood asserts that penalty should be abated because it relied in good faith on E&Y's professional advice in entering into the subject transactions with KFR.

The Division's regulations provide that "in determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability" (20 NYCRR 2392.1[g][2]). The regulations provide that reasonable cause and good faith may be present under the following circumstances:

> [T]he reliance by the taxpayer on any written information, professional advice or other facts, provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer upon inquiry as to whether such facts were erroneous. (20 NYCRR 2392.1[g][2][iv].)

In connection with a claim of reliance on professional advice, the regulations provide that "all facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on professional advice as to the treatment of the taxpayer under the Tax Law" (20 NYCRR 2392.1[g][2][a][1]). More specifically, the regulations state that "the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner" (20

NYCRR 2392.1[g][2][iv][a][1][I]). The advice may not be unreasonable or be based on unreasonable factual or legal assumptions (20 NYCRR 2392.1[g][2][iv][a][1][ii], [2]).

Upon review of the record it is concluded that Kellwood has not established reasonable cause and good faith for its failure to properly remit tax. As noted, Kellwood claims that it reasonably and in good faith relied on the reports prepared by E&Y. Those reports listed various business reasons for entering into the KFR transactions. Although such business reasons did not include a need for financing via advances from KFR, the E&Y reports set a discount rate as consideration for the transfers which allocated about 60 percent (and later about 70 percent) to the cost of such financing. Kellwood should have been aware of the disconnect between its stated reasons for entering into the transactions and the consideration paid under the transactions. Further since Kellwood had experience with third-party factoring agreements it should have been aware that its arrangements with KFR were not typical in that they required 100 percent advances while, more typically, smaller advances are requested. Such red flags notwithstanding, Kellwood followed E&Y's recommendation and entered into the agreement. Under such circumstances it cannot be concluded that Kellwood's reliance on E&Y's professional advice was reasonable or in good faith. Accordingly, penalty is properly sustained.

O. The petition of Kellwood Company is denied, and the Notice of Deficiency dated October 11, 2005 is sustained.

DATED: Troy, New York
March 27, 2008

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE