

STATE OF NORTH CAROLINA

BEFORE THE  
SECRETARY OF REVENUE

COUNTY OF WAKE

**IN THE MATTER OF:** )

)  
The Proposed Corporate Franchise )  
and Income Tax Assessments for )  
Fiscal Years ending )  
December 31, 1993 through )  
December 31, 1998 by the )  
Secretary of Revenue of )  
North Carolina )

**FINAL DECISION**  
DOCKET NO. 01-550

vs. )

[Taxpayers] )

An Administrative Hearing was conducted before Eugene J. Cella, Assistant Secretary of the North Carolina Department of Revenue, in the city of Raleigh on July 9 through July 11, 2003, regarding Notices of Tax Assessment proposed against [Taxpayer 1] and [Taxpayer 2]. The Taxpayers were represented by [two attorneys from an out-of-state law firm], and [one attorney from a North Carolina law firm]. The Corporate, Excise, and Insurance Tax Division of the Department of Revenue was represented by Gregory B. Radford, Director, Donna P. Powell, Administrative Officer, and Kay Miller Hobart, Assistant Attorney General, North Carolina Attorney General's Office.

**ISSUES**

The issues to be decided in this matter are as follows:

- I. Whether Taxpayers who licensed their intangibles for use in this State to either affiliated companies or to third-party franchisees were "doing business" in this State within the meaning of G.S. 105-130.3 and G.S. 105-114 so as to be subject to the

corporate income and franchise tax?

- II. Whether the Taxpayers were “excluded corporations” within the meaning of G.S. 105-130.4?
- III. Whether the penalties assessed against Taxpayers were lawful and proper?

### **EVIDENCE**

The following items were introduced by the parties at or subsequent to the hearing as exhibits and made part of the record:

*Submitted by the Department:*

- D-1 Notices of franchise tax and corporate income tax assessments, field auditor’s report, audit worksheets, and correspondence between auditor and [Taxpayer 1] for tax years 12/31/93, 12/31/94, 12/31/95, 12/31/96, 9/30/97, 12/31/97, and 12/31/98 for [Taxpayer 1].
- D-2 Notices of franchise tax and corporate income tax assessments, field auditor’s report, audit worksheets, and correspondence between auditor and [Taxpayer 2]. for tax years 12/31/93, 12/31/94, 12/31/95, 12/31/96, 9/30/97, 12/31/97, and 12/31/98 for [Taxpayer 2].
- D-3 Summary of [Taxpayer 1’s] North Carolina audit adjustments, including updated franchise tax and corporate income tax reports for tax years 12/31/93, 12/31/94, 12/31/95, 12/31/96, 9/30/97, 12/31/97, and 12/31/98 for [Taxpayer 1]. The reports are updated to add interest through 7/15/2003.
- D-4 Summary of [Taxpayer 2’s] North Carolina audit adjustments, including updated franchise tax and corporate income tax reports for tax years 12/31/93, 12/31/94, 12/31/95, 12/31/96, 9/30/97, 12/31/97, and 12/31/98 for [Taxpayer 2]. The reports are updated to adjust the apportionment factor, adjust federal taxable income for the overstatement of state adjustments in tax period 9/30/97, to add estimated tax penalties not originally assessed, and update interest through 7/15/2003.
- D-5 Correspondence dated August 2, 2001 to Department of Revenue from [Taxpayers] protesting the Notices of Franchise Tax Assessment and the Notices of Corporate Income Tax Assessment dated July 18, 2001 for [Taxpayer 1].

- D-6 Correspondence dated September 6, 2001 from Department of Revenue to [Taxpayers] postponing a formal hearing until such time that an informal conference between the Department and Taxpayer could be held.
- D-7 Correspondence dated September 12, 2001 to Department of Revenue from [Taxpayers] protesting the Notices of Franchise Tax Assessment and the Notices of Corporate Income Tax Assessment dated August 15, 2001 for [Taxpayer 2].
- D-8 Correspondence dated September 25, 2001 to Department of Revenue from [Taxpayers] protesting the Notices of Franchise Tax Assessment and the Notices of Corporate Income Tax Assessment dated September 6, 2001 for [Taxpayer 2].
- D-9 Correspondence dated October 5, 2001 from [Taxpayers' attorney] to the Department of Revenue requesting a postponement of the formal administrative hearing and the holding of an informal conference with the Division Director.
- D-10 Correspondence dated October 5, 2001 from [Taxpayers' attorney] to the Department of Revenue requesting a postponement of the formal administrative hearing and the holding of an informal conference with the Division Director.
- D-11 Correspondence dated November 29, 2001 from Eugene J. Cella, Assistant Secretary of Revenue, to Kay Hobart, Assistant Attorney General, North Carolina Department of Justice and [Taxpayers' attorney], scheduling an administrative hearing for [Taxpayer 1] and [Taxpayer 2] for August 7, 2002.
- D-12 Correspondence dated December 3, 2001 from [Taxpayers] providing the Department with information relative to the auditor's adjustments to [Taxpayer 2] for tax years 1993 through 1998.
- D-13 Correspondence dated December 10, 2001 from [Taxpayers' attorney] to Eugene J. Cella confirming that the administrative hearing scheduled to commence on August 7, 2002 is for both [Taxpayer 1] and [Taxpayer 2].
- D-14 Correspondence dated April 10, 2002 from the Corporate, Excise, and Insurance Tax Division to Eugene J. Cella updating the Assistant Secretary on the outstanding issues regarding [Taxpayer 1] and [Taxpayer 2].
- D-15 Correspondence dated April 23, 2002 from [Taxpayers' attorney] to Donna P. Powell of the Corporate, Excise, and Insurance Tax Division, providing a sample copy of [Taxpayer 1's] franchise agreement pursuant to the Department's request dated April 10, 2002.

- D-16 Correspondence dated May 31, 2002 from [Taxpayers' attorney] to Donna P. Powell providing the following documents pursuant to the Department's request dated April 10, 2002:
- D-16(a) A list of affiliated companies filing in North Carolina during the audit period for both [Taxpayer 1] and [Taxpayer 2].
- D-16(b) A list of third party franchisees located in North Carolina during the audit period for [Taxpayer 1].
- D-16(c) A copy of the Affiliate Trademark Usage Agreement between [Taxpayer 1] and [an affiliate of Taxpayer 1].
- D-17 Correspondence dated July 1, 2002 from Gregory B. Radford, Director, Corporate, Excise, and Insurance Tax Division, to Eugene J. Cella requesting a continuance of the administrative hearing scheduled for August 7, 2002.
- D-18 Correspondence dated July 23, 2002 from Eugene J. Cella to [Taxpayers' attorney] extending the date for the administrative hearing from August 7, 2002 until February 26 – 28, 2003.
- D-19 Correspondence dated July 30, 2002 from [Taxpayers' attorney] to Eugene J. Cella acknowledging the rescheduled administrative hearing for February 26 – 28, 2003.
- D-20 Correspondence dated January 13, 2003 from Eugene Cella [Taxpayers' attorney] and Kay Hobart establishing a hearing format for the administrative hearing tentatively scheduled for February 26-28, 2003.
- D-21 Correspondence dated January 21, 2003 from Donna P. Powell to [Taxpayers' attorney] requesting additional information relative to the Taxpayers in preparation for the administrative hearing scheduled for February 26-28, 2003.
- D-22 Correspondence dated January 24, 2003 from Eugene Cella to [Taxpayers' attorney] granting a continuance of the administrative hearing tentatively scheduled for February 26-28, 2003.
- D-23 Correspondence dated January 31, 2003 from Eugene J. Cella to [Taxpayers' attorney] rescheduling the administrative hearing for [Taxpayer 1] and [Taxpayer 2] for July 9, 2003.
- D-24 Correspondence dated June 2, 2003 from [Taxpayers' attorney] to Eugene Cella providing copies of the following expert reports for the Administrative hearing scheduled for July 9, 2003.

- D-24(a) Expert report of [Taxpayers' witness], dated June 2, 2003.
- D-24(b) Opinion Letter of [Taxpayers' witness].
- D-25 Correspondence dated June 2, 2003 from Gregory B. Radford to Eugene J. Cella, notifying the Assistant Secretary of the Department's potential witnesses for the administrative hearing scheduled for July 9, 2003.
- D-26 Copy of "[Taxpayer 1's] Franchise Agreement" between a [Taxpayer 1] franchisee located in North Carolina and [Taxpayer 1] dated August 25, 1998.
- D-27 Copy of "[Taxpayer 2's] Franchise Agreement" between a [Taxpayer 2] franchisee located in North Carolina and [Taxpayer 2] dated February 20, 1990.
- D-28 Correspondence dated June 5, 2003 from Todd McCracken, Revenue Field Auditor, North Carolina Department of Revenue, to a franchisee of [Taxpayer 1], requesting additional factual information and other documents regarding [Taxpayer 1's quality review program].
- D-29 Correspondence dated June 18, 2003, with related attachments, from a franchisee of [Taxpayer 1] to Todd McCracken, responding to the request for additional information regarding [Taxpayer 1's quality review program].
- D-30 Documents regarding [Taxpayer 2's quality review program].
- D-31(a) December 31, 1993 pro-forma federal tax returns for [Taxpayer 1].
- D-31(b) December 31, 1994 pro-forma federal tax returns for [Taxpayer 1].
- D-31 (c) December 31, 1995 pro-forma federal tax returns for [Taxpayer 1].
- D-31(d) December 31, 1996 pro-forma federal tax returns for [Taxpayer 1].
- D-31(e) September 30, 1997 pro-forma federal tax returns for [Taxpayer 1].
- D-31(f) December 31, 1997 pro-forma federal tax returns for [Taxpayer 1].
- D-31(g) December 31, 1998 pro-forma federal tax returns for [Taxpayer 1].
- D-32(a) December 31, 1993 Balance Sheet for [Taxpayer 1].
- D-32(b) December 31, 1994 Balance Sheet for [Taxpayer 1].
- D-32(c) December 31, 1995 Balance Sheet for [Taxpayer 1].
- D-32(d) December 31, 1996 Balance Sheet for [Taxpayer 1].

- D-32(e) December 31, 1997 Balance Sheet for [Taxpayer 1].
- D-32(f) December 31, 1998 Balance Sheet for [Taxpayer 1].
- D-33(a) December 31, 1997 Securities and Exchange Commission 10-K Report for [Taxpayers' parent company].
- D-33(b) December 31, 1998 Securities and Exchange Commission 10-K Report for [Taxpayers' parent company].(partial report)
- D-34(a) 1997 Annual Report for [Taxpayers' parent company].
- D-34(b) 1998 Annual Report for [Taxpayers' parent company].
- D-35 North Carolina Administrative Rule T17 NCAC 5C .0102.
- D-36 North Carolina Department of Revenue Final Decision Docket Number 90-33.
- D-37 North Carolina Department of Revenue Final Decision Docket Number 97-990.
- D-38 North Carolina Tax Review Board Administrative Decision No. 381.
- D-39 Analysis of Royalty Income Earned by Taxpayers for Use of Taxpayers' Trademarks in North Carolina for tax years ended 1993 through 1998.
- D-40 North Carolina Department of Revenue's Pre-Hearing Brief submitted to the Hearings Officer on July 8, 2003.
- D-41(a) Transcript of the Administrative Tax Hearing held July 9, 2003 regarding the proposed assessments against [Taxpayer 1] and [Taxpayer 2].
- D-41(b) Transcript of the Administrative Tax Hearing held July 10, 2003 regarding the proposed assessments against [Taxpayer 1] and [Taxpayer 2].
- D-41(c) Transcript of the Administrative Tax Hearing held July 11, 2003 regarding the proposed assessments against [Taxpayer 1] and [Taxpayer 2].
- D-42 Correspondence dated July 17, 2003 from [Taxpayers' attorney] to Eugene J. Cella requesting additional documentation from the Department post-hearing.
- D-43 Correspondence dated July 18, 2003 from Gregory B. Radford to Eugene J. Cella requesting additional documentation from [Taxpayer 1] and [Taxpayer 2] post-hearing.

- D-44 Correspondence dated July 24, 2003 from [Taxpayers' attorney] to Eugene J. Cella citing objections to the Department's request for additional documentation dated July 18, 2003.
- D-45 Correspondence dated July 25, 2003 from Gregory B. Radford to Eugene J. Cella citing objections to [Taxpayers' attorney's] request for additional documentation dated July 17, 2003.
- D-46 Correspondence dated August 15, 2003 from Eugene J. Cella to both the Department and [Taxpayers' attorney] notifying both parties of the Hearings Officer's decision regarding post-hearing document requests.
- D-47 Correspondence dated October 10, 2003 from Gregory B. Radford to [Taxpayers' attorney] providing additional documents pursuant to the Hearings Officer's instruction.
- D-47(a) Letters from Todd McCracken, auditor for the North Carolina Department of Revenue, to [Taxpayer 1] scheduling the North Carolina tax audit of [three affiliates of Taxpayer 1].
- D-47(b) Correspondence and document request from/to Todd McCracken to/from [Taxpayers] regarding the North Carolina tax audit of [three affiliates of Taxpayer 1].
- D-47(c) Internal memo dated July 23, 2003 from Todd McCracken to Gregory B. Radford clarifying that the auditor did not keep an audit activity sheet during the North Carolina tax audit of [the three affiliates of Taxpayer 1].
- D-47(d) Internal memo dated July 24, 2003 from Steven H. Winter, auditor for the North Carolina Department of Revenue, to Gregory B. Radford clarifying that the auditor did not keep an audit activity sheet during the North Carolina tax audit of [Taxpayer 2].
- D-48 Correspondence dated October 13, 2003 from [Taxpayers' attorney] to Gregory B. Radford providing additional documents pursuant to the Hearings Officer's instruction.
- D-48(a) Service Agreement between [Taxpayer 1] and [an affiliate of Taxpayer 1] dated March 29, 1993.
- D-48(b) Service Agreement between [Taxpayer 1] and [an affiliate of Taxpayer 1] dated March 29, 1993.
- D-48(c) Service Agreement between [Taxpayer 1] and [an affiliate of Taxpayer 1] dated March 29, 1993.

- D-48(d) Nevada Property Management Agreement between [Taxpayer 1] and [an affiliate of Taxpayer 1] dated December 29, 1989.
- D-48(e) Internal memo dated December 31, 1991 from [an employee of Taxpayer 1] memorializing an oral agreement to form [an affiliate of Taxpayer 1].
- D-48(f) Copy of a License Agreement dated October 13, 2003 between [Taxpayer 2] and [an affiliate of Taxpayer 2].
- D-48(g) Copy of an April 1991 [agreement] between [Taxpayer 1] and [an unrelated entity].
- D-48(h) Copy of a February 1993 [agreement] between [an affiliate of Taxpayer 1] and [an unrelated entity].
- D-48(i) Copy of database listing of [Taxpayer 1's quality review scores] for its North Carolina locations during the years at issue.
- D-48(j) Copy of [Taxpayer 2's operating procedures handbook] dated March 1998.
- D-48(k) List of [Taxpayer 2's] operated restaurants properties during 2001.
- D-48(l) Copies of Utah employment payroll reports for [Taxpayer 2] filed during the audit period.
- D-48(m) List of [Taxpayer 1's] Nevada operated restaurants for the year ended 1994.
- D-48(n) Copies of Nevada wage reports for each quarter of 1996, 1997, and 1998.

*Submitted by the Taxpayers:*

- TP-1 Petitioners' Pre-Hearing Brief submitted to the Hearings Officer on July 8, 2003.
- TP-2 Report entitled "Analysis of [Taxpayer 1] and [Taxpayer 2]" prepared by [Taxpayers' witness] dated June 2, 2003.
- TP-3 Resume entitled "Analysis of [Taxpayers' witness]."
- TP-4(a) Report entitled "Opinion Letter of [Taxpayers' witness]– [Taxpayer 1] and [Taxpayer 2]."
- TP-4(b) Resume entitled "Analysis of [Taxpayers' witness]."
- TP-5 Flow Chart of [Taxpayer 2].
- TP-6 Flow Chart of [Taxpayer 1].



- TP-7 Omitted.
- TP-8 Affidavit of [Taxpayers' witness] dated July 7, 2003.
- TP-9 Affidavit of [Taxpayers' witness] dated September 29, 2003 with attachments.
- TP-10 Petitioners' Post-Hearing Answer Brief dated March 31, 2004.

### **FINDINGS OF FACT**

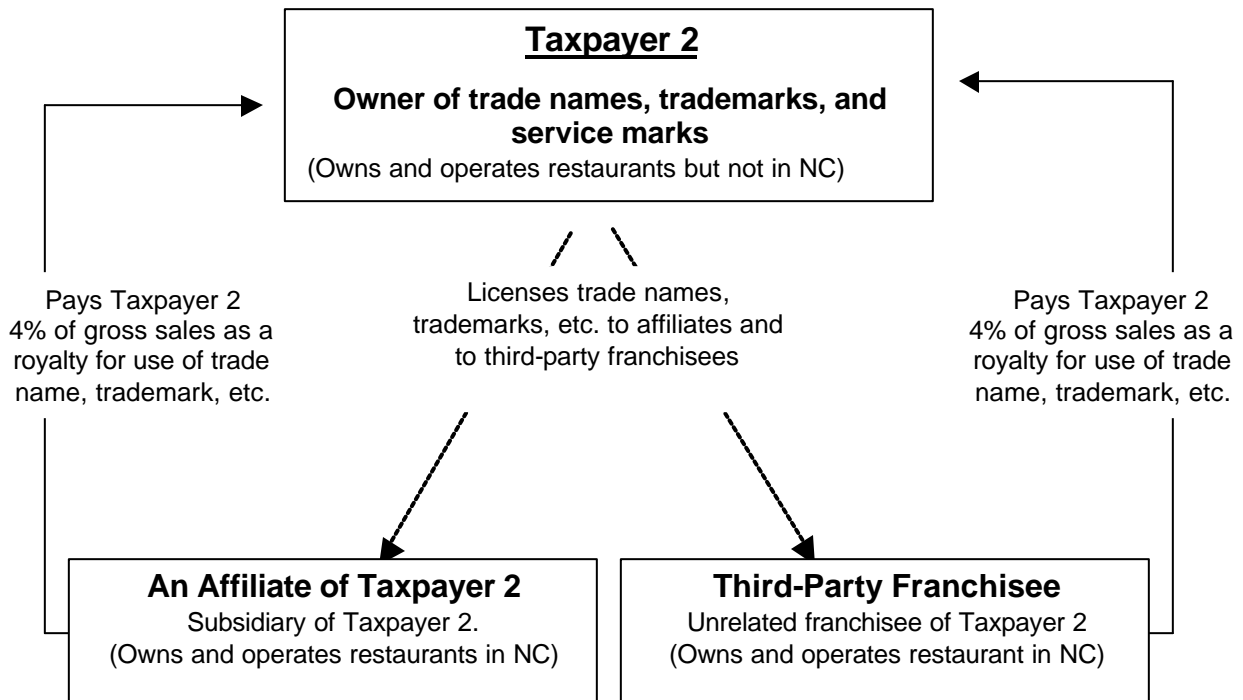
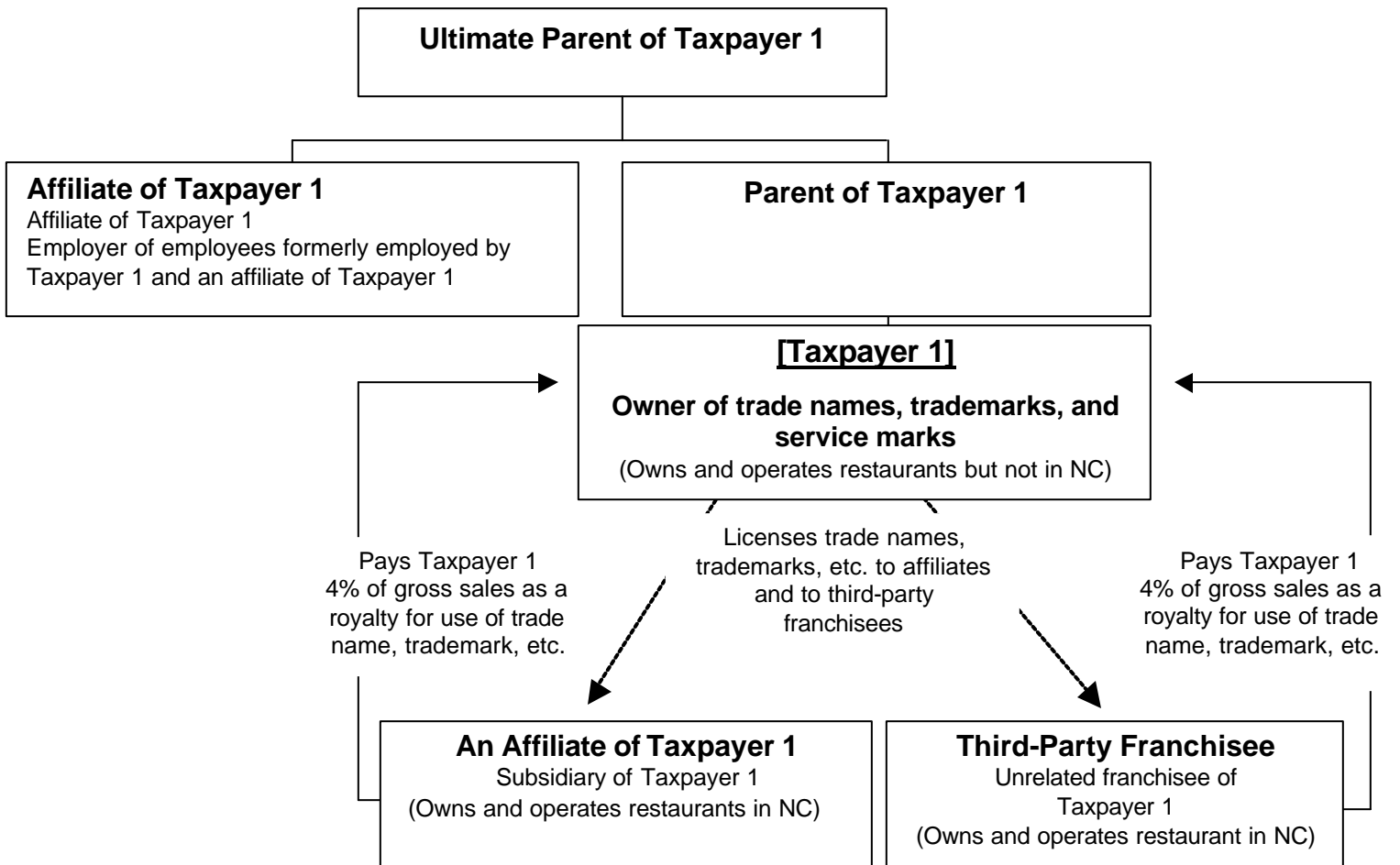
Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. [Taxpayer 1] and [Taxpayer 2], collectively referred to as Taxpayers, are corporations with their principal offices and headquarters located outside of North Carolina.
2. Taxpayers are wholly-owned subsidiaries of [parent of Taxpayers].
3. [Parent of Taxpayers] is a holding company and the sole owner of four operating subsidiaries engaged in the operation and franchising of fast-food restaurants.
4. [Parent of Taxpayers'] principal place of business and commercial domicile is located in [another state].
5. [Parent of Taxpayers'] four operating subsidiaries are: [Taxpayer 2], [Taxpayer 1], [a related entity ], and [another related entity].
6. Each of [parent of Taxpayers'] four operating subsidiaries develop, operate, franchise, and license restaurants using the trade names of [Taxpayer 2], [Taxpayer 1] and [a related entity].
7. All of the restaurants conducting business under the trade names of [Taxpayer 2] and [Taxpayer 1] are owned and operated by Taxpayers, their affiliates, or by third-party franchisees.
8. As part of an acquisition of [a submerged corporation] by an entity not at issue, [Taxpayer 1] was incorporated in Delaware on February 11, 1971.
9. In July 1971, all of the assets of [a submerged corporation], including its trademarks and trade names, were merged into [Taxpayer 1].

10. [Taxpayer 1] is principally located in [another state].
11. After numerous acquisitions and spin-offs, [Taxpayer 1] became a part of [parent of Taxpayers] on October 6, 1997.
12. [A submerged corporation] was incorporated in Delaware on June 25, 1969.
13. [A submerged corporation] merged into [another submerged corporation] on January 23, 1970 and changed its name to [Taxpayer 2].
14. [Taxpayer 2] was acquired by [an unrelated entity not at issue] in 1977.
15. [An unrelated entity not at issue] spun off [Taxpayer 2] on October 6, 1977. [Taxpayer 2] then became a part of [parent of Taxpayers].
16. [Taxpayer 2] is principally located in [another state].
17. Taxpayers are the owners and holders of enormously valuable trade names, trademarks, service marks, merchandizing designs, secret food recipes, formulas, and other confidential information associated with the operation of the [Taxpayer 2] and [Taxpayer 1] restaurant chains.
18. Taxpayers incurred substantial expenses in the development of their trade names, trademarks, and service marks associated with the operation of the [Taxpayer 2] and [Taxpayer 1] restaurant chains.
19. Taxpayers' trademarks, trade names, service marks and unique operating styles have developed name recognition within the restaurant industry.
20. Taxpayers' trademarks convey an expected standard of food quality and service to the consuming public.
21. Taxpayers' trade names, trademarks, service marks and associated goodwill are a form of intangible personal property.
22. Taxpayers' trademarks are registered and protected under the United States Patent Office and receive the benefit of the Lanham Act, a federal law that provides protection to registered names and service marks.
23. During the years 1993 through 1998, Taxpayers did not own or operate any restaurants in North Carolina nor did they have any offices, resident employees, or tangible property in this State.
24. During the years 1993 through 1998, Taxpayers licensed their trademarks and trade names to affiliated companies and independent third-party franchisees that

operated over 250 restaurants throughout North Carolina that utilized Taxpayers' trademarks on a daily basis.

25. During the years 1993 through 1998, Taxpayers' trademarks and trade names were used in the sale and advertising of food products at North Carolina restaurants.
26. During the years 1993 through 1998, Taxpayers' intangible property was located in this State at the 250 plus North Carolina restaurants that utilized Taxpayers' trademarks and trade names.
27. During the years 1993 through 1998, Taxpayers' trademarks and trade names were physically manifested within North Carolina in the signage, menu boards, paper goods, furnishings, fixtures, etc., at the 250 plus North Carolina restaurants that utilized Taxpayers' trademarks and trade names.
28. [An affiliate of Taxpayer 1] is a controlled, wholly owned subsidiary of [Taxpayer 1].
29. [An affiliate of Taxpayer 1] operates restaurants throughout the United States, including North Carolina.
30. [An affiliate of Taxpayer 1] is an affiliate of [Taxpayer 1] and is the employer of employees formerly employed by [an affiliate of Taxpayer 1], [Taxpayer 1], and other related entities.
31. [An affiliate of Taxpayer 2] is a controlled, wholly owned subsidiary of [Taxpayer 2].
32. [An affiliate of Taxpayer 2] operates restaurants throughout the United States, including North Carolina.
33. The structure of the Taxpayers, their affiliates, and the independent third-party franchisees is illustrated on the following chart:



34. To become a franchisee of Taxpayers, a person must enter into a franchise agreement with Taxpayers.
35. A franchise agreement gives the affiliate or the independent third-party franchisee the right to use Taxpayers' marks, secret recipes, and other confidential information at their particular site or location.
36. Taxpayers' franchise agreement required both the affiliate and the third-party franchisee to pay Taxpayers a royalty fee equal to 4% of the restaurant's monthly gross sales for the use of Taxpayers' intellectual property.
37. During the years 1993 through 1998, the use of Taxpayers' intellectual property in this State generated substantial income for Taxpayers.
38. Taxpayers' franchise agreements charged both affiliates and the third-party franchisees 3% of monthly gross sales for advertising and product promotions.
39. The Taxpayers, as owners of the marks, controlled which franchisees used their marks and where the marks could be used.
40. The Taxpayers, as owners of the marks, controlled to whom the marks were licensed, what fees were charged, and when the licensing agreements expired.
41. The Taxpayers exercised actual control over the franchisees' use of the marks at over 250 North Carolina restaurants and over the nature and quality of the items sold under the marks by the franchisees at these locations.
42. [A witness of Taxpayers] of [Taxpayers' Parent Company] testified in an affidavit dated July 7, 2003, that the Taxpayers were engaged in the business of owning, maintaining, enforcing, and licensing their Intellectual Property.
43. [A witness of Taxpayers] testified in an affidavit dated July 7, 2003 that Taxpayers actively protected and enforced their rights in their intellectual property in several ways including: (1) continuously filing and registering new trademarks with the United States Patent and Trademark Office; (2) filing Affidavits of Use (also known as Declarations of Use) with the United States Patent and Trademark Office with respect to its intellectual property; (3) filing Renewal Applications with the United States and Trademark Office with respect to its intellectual property; (4) registering some of its trademarks as domain names; and (5) pursuing infringers of its intellectual property by writing cease and desist letters or by other actions if deemed necessary.
44. During the years 1993 through 1998, Taxpayers actively licensed their intellectual property to affiliates and to third-party franchisees that operated restaurant locations throughout the United States, including North Carolina.

45. [A witness of Taxpayers] testified in an affidavit dated July 7, 2003 that, pursuant to United States Trademark Law, a person cannot warehouse trademarks. Instead, a trademark must be used and the quality of the goods on which the trademark is placed must be maintained.
46. [A witness of Taxpayers] testified in an affidavit dated July 7, 2003 that, based on her knowledge of Taxpayers, Taxpayers satisfied the requirements of the United States Trademark Law by actively licensing, protecting and maintaining their Intellectual Property.
47. Taxpayers' trade names, trademarks, and service marks were used extensively in North Carolina by over 250 restaurants that utilized Taxpayers' marks in their signage, store layout, menu selections, and advertising.
48. The use of Taxpayers' marks in North Carolina promoted and enhanced the business of both the Taxpayers and the franchisees doing business in North Carolina.
49. Taxpayers purposefully utilized the 250 plus North Carolina restaurants to avail themselves of the North Carolina marketplace.
50. Taxpayers, as owners of the trademarks, controlled the manner in which the trademarks and trade names were used by the affiliates or by the third-party franchisee.
51. Taxpayers' franchise agreements required all products and services bearing Taxpayers' trademarks and trade names to be consistent with the high standards of quality and service established over the years by the Taxpayers with respect to their trademarks and trade names.
52. To preserve and promote the value and goodwill of Taxpayers' marks, Taxpayers' affiliates and the third-party franchisees were required to strictly adhere to all the "detailed and substantial" terms of Taxpayers' franchise agreements.
53. Section 2 of the [Taxpayer 1] franchise agreement provides that over the course of years [Taxpayer 1] had developed a unique system for preparing and marketing food products pursuant to trade secrets, standards and specifications designed to maintain a uniform high quality of product, service and national image.
54. Section 2 of the [Taxpayer 1] franchise agreement provides that [Taxpayer 1] has developed and owns certain trademarks and service marks which enjoy a national reputation.
55. Section 2 of the [Taxpayer 1] franchise agreement provides that in order to enhance the value of the [Taxpayer 1] system and its trademarks and goodwill associated with the trademarks, the franchise agreement places detailed and substantial

obligations on the franchisee including strict adherence to [Taxpayer 1's] requirements regarding menu items, advertising, physical facilities, etc.

56. Section 2 of the [Taxpayer 1] franchise agreement provides that the rights granted to the franchisee are for a limited time and that the value of the trademarks derives principally from certain [Taxpayer 1] trademarks and associated goodwill, designs, systems and processes developed by [Taxpayer 1] at considerable expense and effort.
57. Section 3.1 of the [Taxpayer 1] franchise agreement provides that [Taxpayer 1] grants to the franchisee the right and license to use at the franchisee's restaurant location certain trade names, trademarks and service marks owned by [Taxpayer 1] and to prepare and market approved food products at the restaurant location only in connection with products and services meeting [Taxpayer 1's] quality standards.
58. Section 3.7 of the [Taxpayer 1] franchise agreement provides that the franchisee must strictly comply with the requirements and instructions of [Taxpayer 1] regarding the use of the trademarks, trade names, and service marks used in connection with the products sold utilizing [Taxpayer 1's] marks.
59. Section 3.7 of the [Taxpayer 1] franchise agreement provides that the goodwill associated with [Taxpayer 1's] trademarks, service marks and trade names is the exclusive property of [Taxpayer 1] and that the franchisee derives no benefit from such goodwill. In addition, Section 3.7 provides that any enhancement of the goodwill associated with [Taxpayer 1's] trademarks, service marks and trade names inures to the benefit of [Taxpayer 1].
60. Section 5.1 of the [Taxpayer 1] franchise agreement provides that the franchisee's restaurant has been constructed, established, and prepared to conduct business in strict compliance with all plans, specifications and requirements prescribed by [Taxpayer 1].
61. Section 5.2 of the [Taxpayer 1] franchise agreement provides that the franchisee will diligently develop the franchisee's restaurant business and use its best efforts to market and promote the products offered for sale at the restaurant location.
62. Section 5.3 of the [Taxpayer 1] franchise agreement provides that the franchisee will strictly comply with all reasonable standards, specifications, processes, requirements, and instructions of [Taxpayer 1] regarding the operation of the restaurant business.
63. Section 5.3(a) of the [Taxpayer 1] franchise agreement provides that only approved products can be prepared or sold at the franchisee's restaurant.
64. Section 5.3(h) of the [Taxpayer 1] franchise agreement provides that only signs and menu boards, advertising and promotional material, equipment, supplies,

uniforms, paper goods, packing, furnishings, recipes, and food ingredients which meet [Taxpayer 1] standards and specifications can be used at the franchisee's restaurant.

65. Section 5.5 of the [Taxpayer 1] franchise agreement provides that [Taxpayer 1] will provide to the franchisee a confidential operating manual, and that the franchisee must abide by and may rely upon the confidential operating manual. The confidential operating manual and other information furnished by [Taxpayer 1] in connection with the business of [Taxpayer 1] is the property of [Taxpayer 1] and must be returned to [Taxpayer 1] at the end of the license term.
66. Section 5.6 of the [Taxpayer 1] franchise agreement provides that [Taxpayer 1] and its representatives have the right to enter and inspect each restaurant to discuss with the franchisee all matters that pertain to the strict requirements of the franchise agreement.
67. Section 6.2 of the [Taxpayer 1] franchise agreement provides that the franchisee will comply with all standards, specifications, processes, procedures, requirements and reasonable instructions of [Taxpayer 1] regarding the restaurant's physical appearance, including the layout of furnishings and fixtures.
68. Section 7 of the [Taxpayer 1] franchise agreement provides that [Taxpayer 1] will offer to the franchisee initial and continuing services as [Taxpayer 1] deems necessary or advisable in connection with furthering the business of the franchisee and the [Taxpayer 1] system and in connection with protecting the trade names, trademarks, service marks and goodwill of [Taxpayer 1].
69. Section 8.1 of the [Taxpayer 1] franchise agreement provides that the franchisee must pay [Taxpayer 1] a royalty fee of 4% of gross revenues for each month the restaurant is in operation.
70. [Taxpayer 1] profits directly from the gross revenues generated from North Carolina restaurants utilizing [Taxpayer 1's] trademarks and service marks.
71. Section 11.2 of the [Taxpayer 1] franchise agreement provides that [Taxpayer 1] or its authorized agent has the right to request, receive, inspect and audit the financial records of the franchisee. If upon audit a deficiency equally or exceeding 2% of royalties due is discovered, the franchisee must pay [Taxpayer 1] the entire cost of the audit.
72. Section 20.7 of the [Taxpayer 1] franchise agreement provides that the franchisee will immediately inform [Taxpayer 1] of any suspected or known infringement of or challenge to [Taxpayer 1's] trademarks and will assist and cooperate with [Taxpayer 1] in taking action against the infringer as [Taxpayer 1] deems appropriate.



73. The [Taxpayer 2] franchise agreement provides that [Taxpayer 2] has developed and owns a system for selling food products including distinctive signs, food recipes, uniforms, and various trade secrets and other confidential information.
74. The [Taxpayer 2] franchise agreement provides that [Taxpayer 2] has developed its own unique system through the expenditure of time, money, and effort and has maintained a high standard of quality and service. As a result of [Taxpayer 2's] high standard of quality and service, [Taxpayer 2's] "system" has acquired valuable goodwill and a favorable reputation.
75. The [Taxpayer 2] franchise agreement provides that [Taxpayer 2] identifies its "system" through the use of certain trademarks, trade names, service marks, symbols, slogans, emblems, logos, designs, etc.
76. The [Taxpayer 2] franchise agreement provides that [Taxpayer 2's] trademarks, trade names, etc. identify for the public a high standard of quality.
77. The [Taxpayer 2] franchise agreement provides that the franchisee must operate its restaurant in strict accordance with the standards and specifications of [Taxpayer 2].
78. Article II(A) of the [Taxpayer 2] franchise agreement provides that [Taxpayer 2] will help the franchisee select a suitable location for establishing a [Taxpayer 2] restaurant.
79. Article II(C) of the [Taxpayer 2] franchise agreement provides that [Taxpayer 2] will provide the franchisee, upon the franchisee's request, a [Taxpayer 2] representative at the franchisee's restaurant location for the first (3) days of operation to train personnel and assist in opening the restaurant location.
80. Articles II(E) and III (A-B) of the [Taxpayer 2] franchise agreement provides that [Taxpayer 2] will provide on loan to the franchisee a copy of [Taxpayer 2's] operating manual. The operating manual promulgates [Taxpayer 2's] standards of operation for each restaurant utilizing [Taxpayer 2's] trademarks including the standards of quality, cleanliness, and service for all food, beverages, furnishings, interior and exterior décor, supplies, fixtures, and equipment used in connection with each [Taxpayer 2] restaurant.
81. Article III(C) of the [Taxpayer 2] franchise agreement provides that [Taxpayer 2] may require extensive structural changes, major remodeling and renovation, and substantial modifications to the restaurant.
82. Article IV(A)(1) of the [Taxpayer 2] franchise agreement provides that in order to preserve and promote the value and goodwill of [Taxpayer 2's] marks the franchisee must conduct its business consistent with the standards promulgated by [Taxpayer 2] and in strict compliance with the franchise agreement.

83. Article IV(A)(2) of the [Taxpayer 2] franchise agreement provides that the franchisee will not manufacture, advertise for sales, sell, or give away any product that has not been approved by [Taxpayer 2].
84. Article IV(A)(7) of the [Taxpayer 2] franchise agreement provides that the franchisee will operate its restaurant as a clean, orderly, legal, and respectable place of business in accordance with [Taxpayer 2's] business standards.
85. Article IV(C) of the [Taxpayer 2] franchise agreement provides that [Taxpayer 2's] authorized representatives have the right to enter and examine the franchisee's restaurant, conferring with the franchiser's employees, inspecting and checking operations, food, beverages, furnishings, interior and exterior décor, supplies, fixtures, and equipment for the purpose of determining whether the restaurant's business is being conducted in accordance with [Taxpayer 2's] standards and terms of the franchise agreement.
86. Article IV(C) of the [Taxpayer 2] franchise agreement provides that in the event that an inspection indicates any deficiency, the franchisee has 48 hours from receipt of the report (or other time period as directed by [Taxpayer 2]) to correct or repair the deficiency. In the event the franchisee fails to correct the deficiency, [Taxpayer 2] has the right to correct the deficiency at the franchisee's expense.
87. Article VII(D) of the [Taxpayer 2] franchise agreement provides that the franchisee must immediately notify [Taxpayer 2] in writing of any third party infringing upon [Taxpayer 2's] marks.
88. Article VII(E) of the [Taxpayer 2] franchise agreement provides that the goodwill arising from the franchisee's use of [Taxpayer 2's] marks and the [Taxpayer 2] system inures to the benefit of [Taxpayer 2].
89. Article IX(1) of the [Taxpayer 2] franchise agreement provides that the franchisee must pay [Taxpayer 2] an initial franchise fee of \$9,000.
90. Article IX(2) of the [Taxpayer 2] franchise agreement provides that the franchisee must pay [Taxpayer 2] a monthly service fee of 4% per month of the previous month's gross sales.
91. [Taxpayer 2] profits directly from the gross revenues generated from North Carolina restaurants utilizing [Taxpayer 2's] trademarks and service marks.
92. Article X of the [Taxpayer 2] franchise agreement provides that [Taxpayer 2] or its authorized agent had the right to examine and audit the financial records of the franchisee. If upon audit a deficiency equal to or exceeding 5% is discovered, the franchisee must pay [Taxpayer 2] the entire cost of the audit.

93. The Taxpayers, as owners of the marks, controlled the manner in which the trademarks and trade names were displayed at the restaurants located throughout North Carolina.
94. The International Franchise Association states that “franchising is successful because consumers rely on the assurance of consistency, quality, reputation, and value” of the franchiser.
95. The franchise agreements provides that all products sold by affiliates and by the third-party franchisees bearing Taxpayers’ trademarks and trade names must be consistent with the high standards of quality and excellence established by the Taxpayers with respect to their trademarks and trade names.
96. The franchise agreements grants Taxpayers’ franchisees the right to use Taxpayers’ trademarks and trade names only in connection with products and services that meet Taxpayers’ strict quality standards.
97. The Taxpayers, as owners of the marks, controlled the use of the marks in North Carolina and the nature and quality of goods sold under the marks by affiliates and by the third-party franchisees located in North Carolina.
98. [A witness of Taxpayers], Assistant Secretary of [Taxpayer 1], testified that the trademarks are the backbone of [Taxpayer 1].
99. [A witness of Taxpayers] testified that [Taxpayer 1] was the owner of [Taxpayer 1’s] trademarks and that other related affiliates, including [an affiliate of Taxpayer 1], policed and protected those marks.
100. Pursuant to a service agreement dated March 29, 1993 between [an affiliate of Taxpayer 1] and [Taxpayer 1], [an affiliate of Taxpayer 1] agreed to provide certain quality assurance services on behalf of [Taxpayer 1] to [Taxpayer 1’s] franchisees. These services included providing resources and personnel to [Taxpayer 1’s] franchisees and licensees upon [Taxpayer 1’s] request to help keep [Taxpayer 1’s] franchisees and licensees informed of [Taxpayer 1’s] practices and procedures; and acting as a spokesperson for, or disseminating information on behalf of [Taxpayer 1] to [Taxpayer 1’s] franchisees or licensees.
101. According to Taxpayers, pursuant to an oral agreement between [an affiliate of Taxpayers] and [an affiliate of Taxpayers], [an affiliate of Taxpayers] transferred all of its employees to [an affiliate of Taxpayers] on January 1, 1992.
102. Taxpayers were “not aware” of any written agreement between [an affiliate of Taxpayers] and [an affiliate of Taxpayers] that permitted the employees of [an affiliate of Taxpayers] to perform services on behalf of [an affiliate of Taxpayers].

103. There is no evidence that [an affiliate of Taxpayers] compensated [an affiliate of Taxpayers] for the use of [an affiliate of Taxpayer's] employees.
104. Pursuant to an internal memo dated December 31, 1991 from [a witness of Taxpayers], upon creation of [an affiliate of Taxpayers], [Taxpayer 1] would realize \$1,225,000 in state unemployment taxes over a three year period due to lower state unemployment tax rates.
105. During the audit period, [an affiliate of Taxpayers] had no employees. All of the employees formerly employed by [an affiliate of Taxpayers] had been previously transferred to [an affiliate of Taxpayers].
106. According to Taxpayers' internal memo, on January 1, 1992, [an affiliate of Taxpayers] became the employer of the employees formerly employed by [an affiliate of Taxpayers], [Taxpayer 1], and other related entities including restaurant-level employees located in restaurants owned by [an affiliate of Taxpayers] and field-level employees including Franchise Operation Managers.
107. The Franchise Operation Managers, employed by [an affiliate of Taxpayers] visited restaurants utilizing [Taxpayer 1's] trademarks and trade names to ensure restaurant maintenance and cleanliness, product quality, and adherence to [Taxpayer 1's] best demonstrated practices and procedures. The Franchise Operations Managers also monitored the in-store retailing and marketing activities of restaurants bearing [Taxpayer 1's] marks as well as assisted in the introduction of new products.
108. During the years 1993 through 1998, the Franchise Operation Mangers performed services on behalf of [Taxpayer1] in North Carolina.
109. According to Taxpayers, the Franchise Operations Managers visited each restaurant bearing [Taxpayer 1's] trademarks, including the ones located in North Carolina, approximately 2 times per year on average.
110. [A witness of Taxpayers], Vice President of Franchise Administration for [Taxpayer 1], testified that during the audit period [Taxpayer 1] subcontracted with [an affiliate of Taxpayer 1] to perform inspections of restaurants bearing the [Taxpayer 1] trademarks. During these visits, the inspector looks at the procedures which are being used at the restaurant including taking the temperature of products being prepared, looking for health threats such as cross-contamination and employees of the franchisee washing their hands, and inspecting anything which may pose a public health hazard. An inspection report is forwarded by the inspector to [Taxpayer 1].
111. [A witness of Taxpayers] testified that if a representative of [an affiliate of Taxpayer 1] discovers a failure in the franchisee's methods of operation, a report is sent by the representative of [an affiliate of Taxpayer 1] to [Taxpayer 1] where the inspection report is evaluated. [Taxpayer 1] then notifies the franchisee that a second

inspection will be performed. [A witness of Taxpayers'] testified that the representative of [an affiliate of Taxpayer 1], under its subcontract agreement with [Taxpayer 1], inspects the franchisee's restaurant for a second time, and if the second inspection discovers a subsequent failure by the franchisee, the representative of [an affiliate of Taxpayer 1] notifies [Taxpayer 1] of the failed inspection in a report that is sent to [Taxpayer 1]. [Taxpayer 1] then makes a decision whether or not to issue a notice of default under the terms of [Taxpayer 1's] franchise agreement.

112. [A witness of Taxpayers] testified that under [Taxpayer 1's] franchise agreement, the franchisee has thirty days in which to cure a "default" and then a third inspection is performed by a representative of [an affiliate of Taxpayer 1]. [A witness of Taxpayers] also testified that after the inspection, the representative of [an affiliate of Taxpayer 1] forwards the inspection report to [Taxpayer 1]. If there is a third failure by the franchisee, [Taxpayer 1] makes a determination of whether or not to terminate the franchise agreement with the franchisee
113. [A witness of Taxpayers] testified that during the audit period, [Taxpayer 1] commissioned representatives of [an affiliate of Taxpayer 1] to perform [quality inspection reviews] at restaurants located in North Carolina.
114. The services performed by the Franchise Operations Managers in North Carolina assisted [Taxpayer 1] in maintaining the goodwill of [Taxpayer 1's] trademarks which inured to the benefit of [Taxpayer 1].
115. The services performed by the Franchise Operations Managers in North Carolina, protected and preserved [Taxpayer 1's] intellectual property, [Taxpayer 1's] business interests, and [Taxpayer 1's] relationships with its customers in this State.
116. The services performed by the Franchise Operations Managers enabled the North Carolina franchisee to maintain its [Taxpayer 1] franchise and earn income from customers in North Carolina which benefited both the franchisee and [Taxpayer 1].
117. The services performed by the Franchise Operations Managers enabled [Taxpayer 1] to earn income in North Carolina.
118. According to Taxpayers, pursuant to an oral agreement, between [Taxpayer 2] and [an affiliate of Taxpayer 2], [Taxpayer 2] agreed to permit the employees of [an affiliate of Taxpayer 2], known as [Taxpayer 2] Franchise Business Coaches, to perform quality assurance services on behalf of [Taxpayer 2] to [Taxpayer 2's] franchisees and licensees for a fee.
119. Taxpayers were "not aware" of any written agreement between [Taxpayer 2] and [an affiliate of Taxpayer 2] that permitted the employees of [an affiliate of Taxpayer 2] to perform services on behalf of [Taxpayer 2].

120. [Employees of an affiliate of Taxpayer 2] visited all restaurants utilizing [Taxpayer 2's] trademarks and trade names to ensure restaurant maintenance and cleanliness, product quality, and adherence to [Taxpayer 2's] best demonstrated practices and procedures. The [employees of an affiliate of Taxpayer 2] also monitored the in-store retailing and marketing activities of restaurants bearing [Taxpayer 2's] marks as well as assisted in the introduction of new products.
121. During the years 1993 through 1998, the [employees of an affiliate of Taxpayer 2] performed services on behalf of [Taxpayer 2] in North Carolina.
122. According to Taxpayers, [the employees of an affiliate of Taxpayer 2] visited each restaurant bearing [Taxpayer 2's] trademarks, including the ones located in North Carolina, approximately 2 times per year on average.
123. [A witness of Taxpayers], Vice President of Franchising for [Taxpayer 2], testified that [employees of an affiliate of Taxpayer 2] visited restaurants bearing the [Taxpayer 2] trademark, including the restaurants located in North Carolina, to perform a [quality inspections].
124. [A witness of Taxpayers] testified that during the audit period, the [quality inspections] audit was a part of [Taxpayer 2's] standards of operation and was the main way quality control occurred.
125. The services performed by [employees of an affiliate of Taxpayer 2] in North Carolina assisted in maintaining the goodwill of [Taxpayer 2's] trademarks which inured to the benefit of [Taxpayer 2].
126. The services performed by the [employees of an affiliate of Taxpayer 2] in North Carolina protected and preserved [Taxpayer 2's] intellectual property, [Taxpayer 2's] business interests, and [Taxpayer 2's] relationships with its customers in this State.
127. The services performed by [employees of an affiliate of Taxpayer 2] enabled the North Carolina franchisee to maintain its [Taxpayer 2] franchise and earn income from customers in North Carolina which benefited both the franchisee and [Taxpayer 2].
128. The services performed by [employees of an affiliate of Taxpayer 2] enabled [Taxpayer 2] to earn income in North Carolina.
129. For the tax years 1993 through 1998, Taxpayers recorded \$79,626,652.00 in royalty income earned from affiliated companies and third-party franchisees located in North Carolina for the use of Taxpayers' trade names, trademarks, services marks, goodwill, and other intangible assets, broken down as follows:

<u>Year</u>	<u>[Taxpayer 1] Royalty Income</u>	<u>[Taxpayer 2] Royalty Income</u>	<u>Total NC Royalty Income</u>
12/93	\$4,928,361.00	\$6,300,447.00	\$11,228,808.00
12/94	5,142,586.00	6,740,652.00	11,883,238.00
12/95	5,447,997.00	7,287,840.00	12,735,837.00
12/96	6,330,366.00	7,297,391.00	13,627,757.00
10/97	241,741.00	5,308,758.00	11,450,499.00
12/97	1,587,509.00	1,773,171.00	3,360,680.00
12/98	<u>7,610,183.00</u>	<u>7,629,650.00</u>	<u>15,239,833.00</u>
<b>Total</b>	<b>\$37,288,743.00</b>	<b>\$42,337,909.00</b>	<b>\$79,626,652.00</b>

130. For tax years ended December 1993 through December 1998, [Taxpayer 1] received more than 50% of its income from investments in or dealing in intangible property.
131. For tax years ended December 1993 through September 1997 and December 1998, [Taxpayer 2] received more than 50% of its ordinary gross income from investments in or dealing in intangible property.
132. For short period ended 12/31/1997, [Taxpayer 2] did not receive more than 50% of its ordinary gross income from investments in or dealing in intangible property.
133. The Taxpayers did not file North Carolina franchise or income tax returns for tax years 1993 through 1998 nor did they pay franchise or corporate income tax to North Carolina.
134. [Taxpayer 1's ultimate parent company] was contacted on June 14, 1999 by Mr. Todd McCracken, Revenue Field Auditor, regarding the activities of [Taxpayer 1's ultimate parent] and its affiliates in this State.
135. An on-site audit of [Taxpayer 1] for North Carolina corporate income and franchise tax was conducted on August 18, 1999.
136. The auditors determined that [Taxpayer 1] was doing business in this State and subject to corporate income and franchise taxation in this State pursuant to G.S. 105-114, 105-122, 105-130.1, and 105-130.3.
137. The auditor requested on January 14, 2000 that [Taxpayer 1] file and pay North Carolina franchise and income tax, apportioning its income to this State as an excluded corporation pursuant to G.S. 105-130.4(a)(4) and 105-130.4(r).
138. The auditor made a second request on August 3, 2000 that [Taxpayer 1] file and pay North Carolina franchise and income tax, apportioning its income to this State as an excluded corporation.

139. For the periods 1993 through 1998, [Taxpayer 1] never filed a corporate income or franchise tax return nor did they pay the tax that was due.
140. On July 18, 2001, assessments of corporate income and franchise taxes were issued for [Taxpayer 1] for tax years ended December 1992 through December 1998 under the authority of G.S. 105-241.1.
141. [Taxpayer 1] was assessed income and franchise taxes for the years ended December 1992 through December 1998.
142. During the audit period, the franchise tax assessments of tax, penalties, and interest through August 16, 2001 for [Taxpayer 1] were as follows:

**Franchise Tax Assessments**

12/31/1992	\$ 41,188.84
12/31/1993	\$ 36,384.39
12/31/1994	\$ 47,105.69
12/31/1995	\$ 45,718.69
12/31/1996	\$ 40,208.69
09/30/1997	\$ -0-
12/31/1997	\$ 2,036.06
12/31/1998	\$ 64.28
<b>Total</b>	<b>212,706.64</b>

143. During the audit period, the corporate income tax assessments of tax, penalties, and interest through August 16, 2001 for [Taxpayer 1] were as follows:

**Income Tax Assessments**

12/31/1992	\$ 372,589.53
12/31/1993	\$ 434,560.67
12/31/1994	\$ 191,049.43
12/31/1995	\$ 100,666.44
12/31/1996	\$ 513,064.53
09/30/1997	\$ 498,013.21
12/31/1997	\$ 145,719.37
12/31/1998	\$ 672,695.67
<b>Total</b>	<b>\$ 2,928,358.85</b>

144. The proposed assessments were based on the State's assertion that [Taxpayer 1] was doing business in North Carolina by virtue of its activities of licensing intangibles for use in North Carolina and using in-state representatives in furtherance of its business activities.



145. On August 2, 2001, [Taxpayer 1] timely protested the proposed corporate income and franchise tax assessments and reserved the right to a hearing before the Secretary of Revenue.
146. For the periods 1993 through 1998, [Taxpayer 2] never filed a corporate income or franchise tax return nor did they pay the tax that was due
147. [Taxpayer 2] was contacted by Mr. Steven Winters, Revenue Field Auditor, regarding the activities of [Taxpayer 2] and its affiliates in this State.
148. An on-site audit of [Taxpayer 2] for North Carolina corporate income and franchise tax was conducted by Mr. Steven Winters.
149. Based upon the information received during audit, the auditor determined that [Taxpayer 2] was subject to corporate income and franchise taxation in this State pursuant to G.S. 105-114, 105-122, 105-130.1, and 105-130.3.
150. On September 6, 2001 and October 11, 2001, assessments of corporate income and franchise taxes were issued for [Taxpayer 2] for tax years ended December 1992 through December 1998 under the authority of G.S. 105-241.1.
151. [Taxpayer 2] was assessed income and franchise taxes for the years ended December 1992 through December 1998.
152. During the audit period, the franchise tax assessments of tax, penalties, and interest for [Taxpayer 2] were as follows:

**Franchise Tax Assessments**

12/31/1992	\$	85,657.72
12/31/1993	\$	97,600.38
12/31/1994	\$	115,333.43
12/31/1995	\$	144,333.00
12/31/1996	\$	138,266.66
09/30/1997	\$	105,081.82
12/31/1997	\$	27,275.89
12/31/1998	\$	<u>118,817.99</u>
<b>Total</b>	<b>\$</b>	<b>832,366.89</b>

153. During the audit period, the corporate income tax assessments of tax, penalties, and interest for [Taxpayer 2] were as follows:

**Income Tax Assessments**

12/31/1992	\$	873,630.08
12/31/1993	\$	941,738.76

12/31/1994	\$ 1,169,266.33
12/31/1995	\$ 1,509,344.36
12/31/1996	\$ 1,011,435.43
09/30/1997	\$ 720,230.37
12/31/1997	\$ 127,292.53
12/31/1998	\$ 672,331.37
<b>Total</b>	<b>\$ 7,025,269.23</b>

154. The proposed assessments were based on the State's assertion that [Taxpayer 2] was doing business in North Carolina by virtue of its activities of licensing intangibles for use in North Carolina and the utilization of in-state representatives in furtherance of its business activities.
155. On September 25, 2001 and October 30, 2001, [Taxpayer 2] timely protested the proposed corporate income and franchise tax assessments and reserved the right to a hearing before the Secretary of Revenue.
156. An application for hearing was timely filed on October 5, 2001.
157. Pursuant to Final Decision 97-990, the Department cancelled the 12/31/1992 proposed franchise and corporate income tax assessments.
158. Based on additional information received from representatives of Taxpayers on December 3, 2001, the Department adjusted the franchise and corporate income tax assessments of [Taxpayer 2] to recalculate the apportionment factor, adjust federal taxable income due to an overstatement of state adjustments in tax period 9/30/97, add estimated tax penalties not originally assessed, and update interest through July 15, 2003. The adjusted amount of franchise and corporate income tax due is summarized below:

#### **Franchise Tax Assessments**

12/31/1992	\$ -0-
12/31/1993	\$ 61,681.00
12/31/1994	\$ 74,449.00
12/31/1995	\$ 102,355.00
12/31/1996	\$ 111,980.00
09/30/1997	\$ 84,974.00
12/31/1997	\$ (35,115.00)
12/31/1998	\$ 64,970.00
<b>Total</b>	<b>\$ 465,294.00</b>

#### **Income Tax Assessments**

12/31/1992	\$ -0-
12/31/1993	\$ 604,774.00

12/31/1994	\$ 765,469.00
12/31/1995	\$ 1,088,186.00
12/31/1996	\$ 838,212.00
09/30/1997	\$ 486,771.00
12/31/1997	\$ 31,663.00
12/31/1998	\$ 369,358.00
<b>Total</b>	<b>\$ 4,184,433.00</b>

159. An Administrative Tax Hearing before the Secretary of Revenue was conducted by the hearings' officer on Wednesday, July 9 through Friday, July 11, 2003 in the Revenue Building at 501 North Wilmington Street in Raleigh, North Carolina.
160. On February 11, 2004, the Department received a check from [Taxpayer 1] in the amount of \$156,963.80, representing the full amount of corporate income and franchise tax assessed, interest and penalties for tax year 1995. [Taxpayer 1] demanded a refund from the Department for the amount paid. The Department denied [Taxpayer's 1] request for refund.

### CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. G.S. 105-130.3 imposes a tax upon the State net income of every C corporation doing business in this State on the corporation's State net income.
2. The Taxpayers are C corporations.
3. G.S. 105-130.2(5c) defines "state net income" as a taxpayer's federal taxable income as determined under the Internal Revenue Code, adjusted as provided in G.S. 105-130.5.
4. Royalty income earned from the business of owning, maintaining, and licensing trademarks from both affiliates and third-party franchisees is properly includable in Taxpayers' federal taxable income under IRC § 61.
5. G.S. 105-130.5 contains no provision to deduct royalties that are included in federal taxable income.
6. G.S. 105-122 imposes a franchise tax upon every corporation domesticated under the laws of this State or doing business in this State.
7. The Taxpayers are not domesticated under the laws of this State.

8. For franchise tax purposes, “doing business” is defined as “[e]ach and every act, power or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State.”
9. North Carolina Administrative Rule 17 NCAC 5C .0102 was promulgated by the Secretary of Revenue under authority of G.S. 105-262 and 105-264.
10. Administrative Rule 17 NCAC 5C .0102 is *prima facie* correct.
11. Administrative Rule 17 NCAC 5C .0102 defines “doing business,” in pertinent part, as “the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to . . . the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to . . . [t]rademarks, tradenames, [and] franchise rights.”
12. The Taxpayers own intangible property in the form of franchise rights, patented recipes, trade names, trademarks, service marks and the goodwill associated with these marks.
13. A trademark has no independent significance apart from the goodwill it symbolizes; if there is no established business and no goodwill, a trademark symbolizes nothing.
14. A trademark cannot exist apart from the going business in which it is used.
15. Trademark rights are wholly dependent upon actual use.
16. The actual use of a symbol as a trademark in the sale of goods creates and builds up rights in a mark.
17. Lack of actual use can result in loss of legal rights in the mark, known as “abandonment.”
18. The Taxpayers licensed their intangible property, in the form of trademarks, tradenames, service marks and associated goodwill, to affiliated companies and to third-party franchisees for use in this State.
19. If a trademark owner licenses the mark, the owner must control the nature and quality of the goods sold under the mark and must at all costs avoid deceiving the public.
20. The concept of quality control has been incorporated into the Lanham Act by the “related company” doctrine.

21. Under the Lanham Act, a “related company” is “any person whose use of the mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used.”
22. If the owner controls the use of the mark by the licensee, the owner obtains the benefits of Section 5 of the Lanham Act, and the licensee’s use of the mark is attributed to and inures to the benefit of licensor, the owner of the mark.
23. If the owner of a trademark does not exercise sufficient actual control over the use of the mark by the licensee, the owner loses its rights in the mark through abandonment.
24. The trademark owner must exercise *actual* control over the licensee’s use of the mark. Mere paper control, such as a quality control provision in a licensing agreement, without actual control is insufficient. The mere legal right to control is insufficient, as is the voluntary exchange of information.
25. Under the related company doctrine, if the Taxpayers exercised sufficient actual control over the operations of the affiliated companies and the third-party franchisees in North Carolina with regard to the use of the marks and the nature and quality of the goods sold under the marks, the use of the marks by the affiliated companies and the third-party franchisees located in North Carolina is attributed to and inures to the benefit of the Taxpayers.
26. Absent sufficient actual control by the Taxpayers over the affiliate and the third-party franchisees’ use of the marks in North Carolina and the nature and quality of the goods sold under the marks in this State, the use of the marks by the affiliated companies and the third-party franchisees is not attributed to the Taxpayers.
27. Section 1201.03(f) of United States Patent and Trademark Office Trademark Manual of Examining Procedure states that stores that are operating under franchise agreements from another party are considered ‘related companies’ of that party, and the use of the marks by the franchisee/store inures to the benefit of the franchisor.
28. Section 1201.03(f) of United States Patent and Trademark Office Trademark Manual of Examining Procedure states that in all franchise and license situations, the key to ownership is the nature and extent of the control by the applicant of the goods or services to which the mark is applied. A trademark owner who fails to exercise necessary controls over licensees or franchisees may be found to have abandoned its rights in the mark.
29. If use by the affiliated companies and the third-party franchisees of Taxpayers’ marks were not attributed to Taxpayers, Taxpayers’ marks would be abandoned.

30. Both the affiliated companies and the third-party franchisees are “related companies” under the related company doctrine of trademark law.
31. The intangibles owned by the Taxpayers and used at over 250 restaurants in this State have acquired a business situs in North Carolina.
32. The Taxpayers own income-producing property in North Carolina.
33. The regular and systematic use of the Taxpayers’ marks by both the affiliated companies and third-party franchisees at over 250 restaurant locations in North Carolina is attributed to and inures to the benefit of Taxpayers, thereby protecting and preserving the value and existence of Taxpayers’ trademarks.
34. The use of Taxpayers’ marks by both the affiliated companies and third-party franchisees in North Carolina is essential to the continued existence of the marks.
35. The quality control and trademark protection activities performed by employees of the affiliated companies in North Carolina protect Taxpayers’ marks and are attributed to and inure to the benefit of Taxpayers.
36. The employees of the affiliated companies, in performing the activities of quality control and protection and preservation of Taxpayers’ marks and associated goodwill, act as Taxpayers’ representatives in North Carolina.
37. The activities of the employees of the affiliated companies, acting as Taxpayers’ representatives, enable Taxpayers to maintain and enhance a market in this State.
38. The Taxpayers purposefully availed themselves of the benefits of an economic market in North Carolina.
39. The Taxpayers regularly and systematically exploited the North Carolina marketplace for economic gain.
40. The Taxpayers’ business activities were purposefully directed towards residents of North Carolina.
41. The Taxpayers operate income-producing business property in North Carolina.
42. The Taxpayers are operating a business activity or enterprise in this State for economic gain.
43. The Taxpayers are “doing business” in this State for corporate income tax purposes.
44. The Taxpayers are “doing business” in this State for corporate franchise tax purposes.

45. For the years ended December 1993 through 1998, Taxpayers both “invest in” and “deal in” their intellectual property, which are intangible property.
46. For tax years ended December 1993 through December 1998, [Taxpayer 1] is an “excluded corporation” under G.S. 105-130.4(a)(4).
47. For tax years ended December 1993 through December 1998, [Taxpayer 1] must apportion its business income using the sales factor as determined under G.S. 105-130.4(l).
48. For tax years ended December 1993 through September 1997 and December 1998, [Taxpayer 2] is an “excluded corporation” under G.S. 105-130.4(a)(4).
49. For tax years ended December 1993 through September 1997 and December 1998, [Taxpayer 2] must apportion its business income using the sales factor as determined under G.S. 105-130.4(l).
50. For short period ended 12/31/1997, [Taxpayer 2] is not an “excluded corporation” under G.S. 105-130.4(a)(4).
51. For short period ended 12/31/1997, [Taxpayer 2] must apportion its business income using the three-factor apportionment formula with a double-weighted sales factor as determined under G.S. 105-130.4(i).
52. The penalties as assessed were proper under G.S. 105-236 subsections 3 through 5 and G.S. 105-163.41.
53. The proposed assessments of corporate income and franchise tax as adjusted by the Department were proper under G.S. 105-241.1.

### **DECISION**

This case presents three issues regarding the corporate income and franchise tax liability of two non-domiciliary corporations that license their intellectual property for use in North Carolina to affiliated companies and to third-party franchisees. The first issue to be addressed is whether the corporations are “doing business” in this State within the meaning of G.S. 105-130.3 and G.S. 105-114 so as to subject them to North Carolina’s corporate income and franchise tax. The second issue is whether the corporations are “excluded corporations” within the meaning of G.S. 105-130.4(a)(4). The third issue is

whether the civil penalties were properly imposed on the corporations by the Department on the facts of this case.

**I. SUMMARY OF THE FACTS**

[Taxpayer 1] and [Taxpayer 2] (referred to individually as “Taxpayer” or collectively as “Taxpayers”) are two non-domiciliary corporations that own trademarks, trade names, service marks (“marks”), and the goodwill associated with these marks. Taxpayers are subsidiaries of [parent of Taxpayers] formerly known as [parent of Taxpayers].

[Taxpayer 1], a Delaware corporation, was incorporated on February 11, 1971, and is principally located in [another state]. [Taxpayer 2], a Delaware corporation, was incorporated on June 25, 1969, and is now principally located in [another state] (previously [another state]).

Taxpayers are the owners and developers of a unique system under which food is sold to the public from restaurants that operate under the trade names “[trade name of Taxpayer 1]” and “[trade name of Taxpayer 2.]” Taxpayers also own well-recognized and valuable trade names, trademarks, service marks, merchandizing designs, secret food recipes, formulas, and other confidential information that are associated with the operation of the [Taxpayer 2] and [Taxpayer 1] restaurant chains. Exhibit D-27, p. 1; Exhibit D-33(a), p. 11; and Exhibit D-34(a), p. 17.

During the periods at issue, Taxpayers did not own or operate any restaurants in North Carolina nor did they have any offices, resident employees, or tangible property in this State. However, Taxpayers did license their intellectual property to affiliated companies and independent third-party franchisees that operated over 250 restaurant locations throughout



North Carolina. On a daily basis, these 250 plus restaurants extensively used Taxpayers' marks in their signage, store layout, menu selections, and advertising.

Each of the Taxpayers entered into franchise agreements with affiliated companies and with third-party franchisees that agreed to operate restaurants in North Carolina according to the specific terms of the franchise agreement. The franchise agreement granted the franchisee the right to use Taxpayers' marks, secret recipes, and other confidential information developed by Taxpayers at the franchisee's particular site or location. Exhibit D-26, p. 2 and Exhibit D-27, p. 1. The franchise agreement also provided that Taxpayers would provide continuing services to the franchisees necessary to protect Taxpayers' trade names, trademarks, service marks and goodwill. Exhibit D-26, p. 9 and Exhibit D-27, p. 4.

During the years at issue, Taxpayers' affiliated companies and third-party franchisees paid Taxpayers a royalty fee equal to 4% of gross sales for the use of Taxpayers' intellectual property at the franchised locations. Exhibit D-26, pp. 10-13 and Exhibit D-27, pp. 8-11, and 13. Taxpayers also charged both affiliates and third-party franchisees 3% of gross sales for advertising and product promotions. *Id.*

[Affiliate of Taxpayer 1] is a controlled, wholly owned subsidiary of [Taxpayer 1]. Exhibit TP-6. During the years at issue, [an affiliate of Taxpayer 1] operated restaurants throughout the United States, including restaurants located in North Carolina. Pursuant to a service agreement, [an affiliate of Taxpayer 1] agreed to provide "certain services" on behalf of [Taxpayer 1] to [Taxpayer 1's] franchisees and/or licensees for a fee. These services included:

- Providing resources and personnel as and when requested by [Taxpayer 1] to help keep [Taxpayer 1] franchisees and/or licensees of [Taxpayer 1] outlets in the U.S. informed of [Taxpayer 1] practices and procedures.
- Acting as spokesperson for, or disseminating information on behalf of, [Taxpayer 1] in all or some of its dealings with franchisees and/or licensees.

Exhibit D-48(a), pp 2 and 3.

According to an internal memo from [Taxpayer 1], on or about January 1, 1992, [the ultimate parent of Taxpayer 1] formed a controlled, wholly owned subsidiary, [an affiliate of Taxpayer 1]. The Taxpayer stated that pursuant to an oral agreement between [an affiliate of Taxpayer 1] and [an affiliate of Taxpayer 1], [an affiliate of Taxpayer 1] transferred all of its employees to [an affiliate of Taxpayer 1]. Exhibit D-48, p. 2. The following employees formerly employed by [an affiliate of Taxpayer 1] became the employees of [an affiliate of Taxpayer 1]:

- Restaurant-level employees located in restaurants owned by [an affiliate of Taxpayer 1].
- Field-level employees including “Franchise Operations Managers” who performed the following services:
  - Conduct restaurant visits to ensure facility maintenance and cleanliness.
  - Ensure product quality.
  - Ensure adherence to best demonstrated practices and procedures.
  - Monitor in-store retailing and marketing activities.
  - Assist in the introduction of new products.
  - Ensure core-training processes were being executed.

*Id.* at 2 and 6.

To perform the services listed above, the “Franchise Operations Managers” employed by [an affiliate of Taxpayer 1] visited each restaurant utilizing Taxpayers’

intellectual property, including the ones located in North Carolina, approximately 2 times per year on average. *Id.* at. 6.

[An affiliate of Taxpayer 2] is a controlled, wholly owned subsidiary of [Taxpayer 2]. Exhibit TP-5. During the years at issue, [an affiliate of Taxpayer 2] operated restaurants throughout the United States, including restaurants located in North Carolina. Exhibit D-41, p. 163. According to the Taxpayer, an oral agreement existed during the audit period between [Taxpayer 2] and [an affiliate of Taxpayer 2] that permitted the employees of [Taxpayer 2] (known as “[Taxpayer 2] Franchise Business Coaches”) to perform certain services on behalf of [Taxpayer 2] for a fee. Exhibit D-41, p. 216, and Exhibit D-48, p. 3. The services performed by [Taxpayer 2] Franchise Business Coaches on behalf of [Taxpayer 2] were as follows:

- Conduct restaurant visits to ensure facility maintenance and cleanliness.
- Ensure product quality.
- Ensure adherence to best demonstrated practices and procedures.
- Monitor in-store retailing and marketing activities.
- Assist in the introduction of new products.
- Ensure core-training processes were being executed.

Exhibit D-48, p. 6.

To perform the services listed above, [Taxpayer 2’s] “Franchise Operations Coaches” visited each restaurant utilizing Taxpayers’ intellectual property, including the ones located in North Carolina, approximately 2 times per year on average. *Id.*

For the tax years ending December 1992 through December 1998, Taxpayers recorded \$79,626,652.00 in royalty income earned from affiliated companies and third-party

franchisees located in North Carolina for the use of Taxpayers' trade names, trademarks, service marks, goodwill, and other intangible assets. Exhibit D-40, p. 11. Taxpayers did not file corporate income or franchise tax returns nor did they pay any corporate income or franchise tax to North Carolina on the income earned in this State for those years.

The Department assessed [Taxpayer 1] \$1,555,891.00 in franchise and corporate income taxes for the period December 1992 through December 1998. The Department also assessed [Taxpayer 1] \$1,585,174.49 in penalty and interest through August 16, 2001. The Department assessed [Taxpayer 2] \$3,879,035.00 in franchise and corporate income taxes for the period December 1992 through December 1998. The Department also assessed [Taxpayer 2] \$3,978,601.12 in penalty and interest through October 3, 2001. Taxpayers filed timely protests of the Notice of Tax Assessments Tax and requested a hearing before the Secretary of Revenue.

On December 3, 2001, Taxpayers furnished additional information regarding the proposed assessments for [Taxpayer 2]. After reviewing this information, the Department recalculated the sales factor for [Taxpayer 2] for tax years 1993 through 1998 and adjusted [Taxpayer 2's] short period return ending 10/31/1997 to correct an overstatement of adjustments made by the North Carolina auditor. In addition, pursuant to Final Decision 97-990, the Department cancelled the 12/31/1992 proposed franchise and corporate income tax assessments for both Taxpayers.

Since the administrative tax hearing, the Department received a check from [Taxpayer 1] in the amount of \$156,963.80, which represents the full amount of corporate income and franchise tax assessed, interest and penalties for tax year 1995. Consequently, that year is no longer a part of this administrative hearing.

## II. TAXPAYERS ARE “DOING BUSINESS” IN NORTH CAROLINA

Taxpayers argue they were not doing business in North Carolina and therefore not subject to corporate income and franchise tax. They contend that, during the years at issue, they did not operate any business enterprise or activity in North Carolina so as to subject them to North Carolina tax, and that they performed all of their “licensing activities” outside of North Carolina. Exhibit TP-1, p.4. Taxpayers specifically argue that [Taxpayer 1] “does what it does” in [another state] and that [Taxpayer 2] “does what it does” in [another state]. Exhibit 41(a), p. 70.

In response, the Department maintains that Taxpayers purposefully availed themselves of the substantial privilege of “doing business” in North Carolina by licensing their valuable intangible property in the form of trademarks and trade names to affiliated companies and to third-party franchisees located in North Carolina for economic gain. The Department further contends that the performance of quality control activities and other services by Taxpayers’ affiliates on behalf of Taxpayers were significant, necessary, and vital to the establishment of Taxpayers’ marketplace, and that these activities established a physical presence for Taxpayers in this State.

I agree with the Department. I find that the Taxpayers were doing business in this State during those years and are subject to North Carolina’s corporate income tax and franchise tax. Consequently, the auditors were correct to propose assessments against Taxpayers based upon their activities of licensing intangibles for use in North Carolina as well as the utilization of in-state representatives in furtherance of Taxpayers’ business activities.

G.S. § 105-122 imposes a franchise tax on every corporation incorporated, domesticated or doing business in this State. For franchise tax purposes, “doing business” is defined as “[e]ach and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State.” G.S. § 105-114(b)(3).

G.S. § 105-130.3 imposes a tax upon the State net income of every C corporation doing business in this State. Although the term “doing business” is not defined by statute for corporate income tax purposes, the Secretary has promulgated an administrative rule defining this term. G.S. §§ 105-262 and 105-264 authorize the Secretary to adopt administrative rules interpreting all laws he administers. Such interpretation is *prima facie* correct. *Polaroid v. Offerman*, 349 N.C. 290, 507 S.E.2d 284 (1998).

Under Administrative Rule 17 NCAC 5C .0102(a), a taxpayer is considered to be “doing business” in this State if it operates any business enterprise or activity in this State for economic gain, including but not limited to the owning, renting, or operating of business or income-producing property in North Carolina. Taxpayers argue that they do not fall within this definition because they were not operating a business enterprise or an activity in North Carolina. Exhibit D-41(c), p. 450. In addition, Taxpayers contend that the Department’s doing business rule exceeds the scope of the statute because it expands the definition of “doing business” beyond what is permitted by statute. Exhibit D-41(a), pp. 69-70.

In a previous Final Decision 90-33 dated March 25, 1992, the former Assistant Secretary of Revenue held that the licensing of intangibles by an out-of-state taxpayer constitutes “doing business” in North Carolina and subjects the company to taxation in

this State. Exhibit D-36. In that case, the issue was whether the earnings from intangible assets (i.e., copyrights, franchise rights, trademarks, and trade names) held by a taxpayer's wholly owned subsidiary constituted income subject to North Carolina taxation under the authority of G.S. 105-130.3. The former Assistant Secretary concluded that a trademark licensing subsidiary was "doing business" in North Carolina through ownership of intangible assets which the trademark company had licensed to North Carolina businesses (restaurant franchisees) and for which the trademark company was paid royalty income. The Secretary further found that the taxpayer's copyrights, franchise rights, trademarks, logos, etc., were "utilized and situated in North Carolina" at the retail locations of its franchisees. *Id.*, p.2.

Similarly, in Final Decision 97-990 (Docket No. 97-990 dated September 19, 2000, affirmed by the Tax Review Board on May 7, 2002, and by the Wake County Superior Court on May 22, 2003), the former Assistant Secretary of Revenue held that North Carolina corporate income and franchise taxes were properly assessed against trademark licensing corporations domiciled outside of North Carolina. In his decision, the Assistant Secretary concluded that the owners of trademarks were "doing business in North Carolina" because they owned, licensed and operated business or income-producing property in North Carolina.

Based upon the facts of that case, the Assistant Secretary concluded that the licensors of trademarks and trade names were doing business in North Carolina because they operated a business enterprise or activity in North Carolina for economic gain. The Assistant Secretary ultimately held that the licensors' activities fell within all three of the possible methods set out in Administrative Rule 17 NCAC 5C .0102(a)(5) by which an

entity could be doing business in this State, because they owned business or income-producing property in North Carolina, they licensed business or income-producing property in North Carolina, and they operated business or income-producing property in North Carolina.

In the case before me, the nature and extent of Taxpayers' activities in North Carolina are well illustrated. While Taxpayers may not have employees or tangible property in North Carolina, the continuity, frequency, and regularity of Taxpayers' activities in North Carolina are readily apparent. Throughout the audit period, Taxpayers continuously and regularly permitted their property to be used in North Carolina for economic gain.

As the record demonstrates, Taxpayers are owners and holders of valuable intangible property in the form of trademarks, trade names, and service marks. Exhibit D-41(a), pp. 77, 139, and 157. Taxpayers' intangible property is located in North Carolina at the 250 plus restaurant locations of the franchisees where the trademarks and trade names are used on a daily basis. *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936).

Taxpayers rent their valuable intangible property in North Carolina by licensing the use of their trademarks and trade names to affiliates and to third-party franchisees, which operated over 250 restaurant locations in North Carolina. *Id.* at 79, 83, 144, 163, and 164. Under the specific terms of Taxpayers' licensing agreements, Taxpayers require the franchisees to make royalty payments to Taxpayers for the privilege of using Taxpayers' property in this State, *Id.* At 144, 163, and 164. Throughout the audit period, Taxpayers earned significant royalty income from the North Carolina franchisees. Exhibit D-40, p. 11. Consequently, Taxpayers both own and license (or rent) their business or income-



producing property in North Carolina in the form of trademarks, trade names, and franchise rights through the licensing agreements with both affiliated companies and third-party franchisees.

Taxpayers also operate business or income-producing in this State through licensing activities. In fact, Taxpayers' primary source of income – their royalties – is dependent upon the use of their property in this State plus North Carolina restaurant location. Taxpayers are therefore operating a business enterprise or activity in North Carolina for economic gain.

Throughout the administrative hearing, Taxpayers argued that physical presence is a constitutional prerequisite for taxation; and since Taxpayers do not have a physical presence in North Carolina, they cannot be taxed by North Carolina. The Taxpayers argue that, because the U.S. Supreme Court in *Quill* held that an out-of-state retailer with no physical presence in the state could not be required to collect use tax on its sales to in-state customers, the Taxpayers here cannot be required to pay North Carolina franchise and corporate income tax. The Taxpayers argue that the physical presence requirement articulated in *Quill* for establishing substantial nexus is not limited to sales and use taxes but is also applicable to North Carolina's franchise and corporate income tax. Exhibit D-41(a), p. 70. While questions of constitutionality are for the courts and outside my authority, *Great American Insurance Company v. Gold*, 254 N.C. 168 (1961), it is my opinion that a physical presence is not required to establish taxable nexus in North Carolina. Here, the continuous use of Taxpayers' marks within North Carolina's economic market, for the purpose of generating substantial income for Taxpayers, establishes sufficient nexus to justify the imposition of North Carolina tax.

Moreover, even if I were to accept Taxpayers' argument that a physical presence is required before taxable nexus in North Carolina can be established, the record in this case demonstrates that Taxpayers are in fact physically present in North Carolina through the many activities performed by Taxpayers' affiliates in North Carolina on their behalf. As held by the United States Supreme Court in *Tyler Pipe Industries v. Washington Dep't of Revenue*, 483 U.S. 232 (1987), the activities of an in-state representative are sufficient to create a taxable presence for an out-of-state company in order for the state to impose a tax. Specifically, the Court stated:

[T]he crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.

*Tyler Pipe*, 483 U.S. at 250; see also *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960).

In this case, I have no difficulty in concluding that the relationships between Taxpayers and their affiliated companies under both written and oral agreements create physical presence in North Carolina for Taxpayers. As the Court held in *Scripto*, the fact that Taxpayers did not use their own employees to utilize their trademarks to generate sales to North Carolina residents is without constitutional significance. I therefore conclude that the myriad of quality assurance activities and other services performed by Taxpayers' affiliates on behalf of Taxpayers in this State confers a physical presence to Taxpayers.

In summary, Taxpayers are doing business in North Carolina because they are operating a business enterprise or activity in North Carolina for economic gain. The Taxpayers' activities fall within all three of the possible methods set out in Administrative Rule 17 NCAC 5C .0102(a)(5) by which an entity could be doing business in this State. If

the Taxpayers' activities fit any one of these methods, the Taxpayers would be doing business in North Carolina. The Taxpayers own business or income-producing property in North Carolina, the Taxpayers license business or income-producing property in North Carolina, and the Taxpayers operate business or income-producing property in North Carolina.

**III. TAXPAYERS WERE “EXCLUDED CORPORATIONS” WITHIN THE MEANING OF G.S. 105-130.4(a)(4).**

For the years at issue, G.S. 105-130.4(a)(4) defined an “excluded corporation” as any corporation that received more than 50% of its ordinary income from “investments in” or “dealing in” intangible property. If Taxpayers are “excluded corporations,” G.S. 105-130.4(r) requires Taxpayers to apportion their business income by multiplying their income by the sales factor as determined under G.S. 105-130.4(l). If Taxpayers are not excluded corporations, they must apportion their business income by multiplying their business income by the general three-factor apportionment formula consisting of property, payroll, and sales as determined under G.S. 105-130.4(i).

Taxpayers argue that since they neither “invest in” or “deal in” their intangible property, they do not satisfy the statutory criteria and can not be taxed as an excluded corporation. Taxpayers contend that the phrase “investments in and/or dealing in” intangibles as used in the statute does not include the activity of licensing trademarks.

Taxpayers have throughout the years “spent significant sums of money” developing and maintaining their trademarks. Exhibit 41(a), p. 136. Taxpayers licensed these trademarks to both affiliated and non-affiliated franchisees for a royalty fee. Taxpayers earned a significant amount of royalty income through its licensing activities, including the activities performed in North Carolina. Exhibit D-40, p. 11 Therefore, in my

opinion, Taxpayers' activities with respect to their trademarks—which include holding, protecting, maintaining, enforcing, managing, and licensing their trademarks—constitute both investing in and dealing in intangible property.

Furthermore, in Final Decision 97-990, the Assistant Secretary rejected the argument that a corporation that receives more than 50% of its gross income from royalties pursuant to licensing agreements does not “invest in” or “deal in” intangible property. I likewise reject that argument here.

For all years at issue, [Taxpayer 1] received more than 50% of its ordinary gross income from royalties and met the statutory definition of “excluded corporation” set forth in G.S. 105-130.4(a)(4). As an excluded corporation, [Taxpayer 1] is required to apportion its business income using the single sales factor.

For all periods except the short-period ended 12/31/97, [Taxpayer 2] received more than 50% of its ordinary gross income from royalties and met the statutory definition of an “excluded corporation” for those periods. As an excluded corporation, [Taxpayer 2] is required to apportion its business income using the single sales factor.

For the short period ended 12/31/1997, because [Taxpayer 2] did not receive more than 50% of its ordinary gross income from intangibles, it did not meet the definition of an “excluded corporation.” Therefore the business income earned by [Taxpayer 2] during the short period ended 12/31/1997 is required to be apportioned using the standard three-factor formula with a double-weighted sales factor.

#### **IV. THE CIVIL PENALTIES AS IMPOSED AGAINST THE TAXPAYERS WERE PROPERLY ASSESSED.**

For the periods at issue, the following penalties were imposed on Taxpayers by the Department: (1) failure to file; (2) failure to pay the tax when due; (3) negligence; and (5)

underpayment of estimated income tax. Taxpayers have requested that all imposed penalties be abated.

The law grants the Secretary of Revenue the authority to waive or reduce all civil penalties imposed on a taxpayer by the Department of Revenue, including the failure to file penalty, the failure to pay penalty, the negligence penalty, and the underpayment of estimated income tax penalty. The Secretary exercises his authority through the established policies and procedures of the Department, including the Department's penalty waiver policy.

The Department's penalty waiver policy outlines two categories of criteria used by the Department when determining whether or not to waive a civil penalty. These criteria are: (1) general waiver criteria; and (2) special circumstances. The category of general waiver criteria consists of three automatic reasons to waive or reduce a penalty and one conditional reason of good compliance record. The three automatic reasons for penalty waiver or reduction include: (1) the death of the taxpayer, the taxpayer's immediate family member, or the taxpayer's tax preparer; (2) serious, sudden illness of the taxpayer, the taxpayer's immediate family member, or the taxpayer's tax preparer that prevented compliance; and (3) natural disaster, such as a tornado or hurricane, or an accident, such as fire, that destroyed property that prevented compliance. The good compliance provision provides that a taxpayer may be granted a penalty waiver by the Secretary if the taxpayer has filed all tax returns due, has paid all tax and interest due on the returns filed, has received no penalty waivers over the past three years, and the penalty imposed was not the result of a repeated mistake made by the taxpayer. Special circumstances are unusual in nature and limited in application. They include such circumstances as action

or inaction by the Department that resulted in an increased liability for the taxpayer, a gray area of the law, or a recent change in Departmental policy.

In this case, the Taxpayers argued that their interpretation of what constitutes substantial nexus is a gray area. Specifically, the Taxpayers argued that there should be no penalties assessed because the issue before this court is “an open important active issue which ultimately will be decided by the United States Supreme Court.” Exhibit D-41(c), p. 452. However, since 1992, the law has been clear in North Carolina that a taxpayer who licenses its trademarks for economic gain in this State is doing business here for corporate income tax purposes. See *17 NCAC 5C .0102*. Furthermore, during the administrative hearing, the Taxpayers testified that they were aware of both Administrative Rule 17 NCAC 5C .0102 and Final Decision 90-33, the North Carolina authorities which clearly set out the Department’s position that corporations, such as Taxpayers, are required to file and pay corporate income and franchise tax. Exhibit D-41(a), pp. 222-223.

During the years at issue, the Taxpayers did not file a franchise and corporate income tax return and set forth their position that no tax was due nor did they pay the tax for the periods at issue and request a refund from the Department. As testified in the hearing, the Taxpayers, with full knowledge of both the Administrative Rule and Final Decision 90-33, consciously chose to disregard the Department’s position and the previous administrative decision of the Secretary. Therefore special circumstances do not apply in this case. The automatic reasons do not apply to Taxpayers. The good compliance provision cannot apply to Taxpayers because they have never filed and paid

franchise and corporate income in this State for several years. There is ample evidence in the record to support the penalties imposed.

Finally, in confirming the former Secretary's decision in Final Decision 97-990, the Tax Review Board concluded that "there [was] ample evidence in the record to support the Department's original imposition of penalties." Exhibit D-38, p. 38. I find that the facts presented in this case are as compelling, if not more so, than the facts in Final Decision 97-990. Therefore for the reasons cited, I decline to waive the penalties imposed on the Taxpayers.

### **CONCLUSION**

After considering the arguments presented at the hearing and the briefs filed by both parties, I find that Taxpayers are doing business in North Carolina and are excluded corporations (with the exception of the year noted in the Department's initial brief). I further find that there is ample evidence in the record to support the Department's imposition of penalties for tax years 1993 through 1998.

The proposed assessments of franchise and corporate income tax, penalties and interest for the tax years 1993 through 1998, as modified by the Department, are correct under the law and are hereby sustained in their entirety and are determined to be final and collectible, together with interest as allowed by law.

This the 1st day of July, 2004.

Signature \_\_\_\_\_

Eugene J. Cella  
Assistant Secretary of Revenue