DISTRICT COURT, CITY AND COUNTY OF DENVER, COLORADO Denver City & County Building 1437 Bannock Street, Room 256 Denver, CO 80202 (720) 865-8301 **Plaintiff:** TARGET BRANDS, INC. **Defendants:** DEPARTMENT OF REVENUE OF THE STATE OF COLORADO; and BARBARA BROHL, in her official capacity as the Executive Director of the Department of Revenue of the State of Colorado.	DATE FILED: January 27, 2017 4:59 PM CASE NUMBER: 2015CV33831 **COURT USE ONLY**
	Case No.: 2015CV33831 Division: 424

FINDINGS OF FACT AND CONCLUSIONS OF LAW

THIS MATTER was tried to the Court from October 17-21, 2016. The parties then filed proposed findings of fact and conclusions of law on November 15, 2016, and closing arguments were heard on November 22, 2016.

SUMMARY

The Department's tax assessment does not violate the Constitution. However, the assessment for 1999-2001 was untimely in light of the 2003 audit.

The Department was justified in invoking Section 18, but the alternative chosen by the Department was not reasonable. TBI was not a shell company and, therefore, its payroll and property (not Target's) should have been part of the tax calculation.

Finally, the Court abates three years of interest because of the Department's admitted undue delay in addressing TBI's protest.

FINDINGS OF FACT

A. The Parties

1. Target Corporation[1] is a Minnesota corporation engaged in the business of making retail sales through multiple retail venues. (Ex. D-45 at 2.) It owns and operates stores in almost every state in the United States, including Colorado. (*Id.*) In 2003, Target had over 25 stores in Colorado. (Ex. P-135 at 2.)

2. In December 1998, in Minneapolis, Minnesota, Dayton Hudson Corporation formed Dayton Hudson Brands, Inc. (which became Target Brands Inc.) as a wholly-owned subsidiary. (TMO at 7, ¶ 2.) Dayton Hudson Brands was a corporation formed under the laws of the State of Minnesota. (Ex. P-25.)[2]

3. Defendant Department of Revenue of the State of Colorado ("Department") is an agency of the State of Colorado, existing and operating under the Constitution and statutes of the State of Colorado.

4. Defendant Barbara Brohl is the Executive Director of the Department.

B. Nature of the Dispute

5. This matter arises from TBI's challenges to corporate income tax assessments ("Assessments") issued by the Department. The Years at Issue are tax years 1999–2009. These tax years correspond to TBI's fiscal years ending January 29, 2000 through January 31, 2010.

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[1] Target Corporation ("Target") was formerly known as Dayton Hudson Corporation.

[2] TBI was formerly known as Dayton Hudson Brands, Inc. The name changes occurred on January 30, 2000. (Exs. D-45 at 2, P-25.)

C. **<u>Target Corporation's Operations Prior to TBI</u>**

6. Target developed and owned its trademarks, tradenames, patents, copyrights, and other intellectual property ("IP"), including the Bullseye logo and the TARGET trademark. (Ex. D-45 at 1-2.) Prior to TBI's creation, Target had begun to focus more on brand development, management and protection, noting in its 1997 Annual Report,

> Our brand is everything. Our guests have come to know us—and differentiate us—by the merchandise we stock in our stores, and how we communicate it through our advertising, promotions and in-store displays. Target's award-winning advertising is a big part of building and supporting the Target brand.

(Ex. P-2 at 23.)

7. Ernst & Young, when completing a transfer-pricing analysis for Target in 1999, observed: "[Target] invests heavily in advertising and public relations to help build and maintain the equivalent of brand equity, thereby increasing the value of [Target's] trademarks, trade names and service marks. The development of proprietary credit cards also reinforces brand identity." (Ex. P-2 at 24.) Target's law department had the primary responsibility for the management and protection of Target's IP. (Tr. 53:1-11, 59:10-60:9.)

8. The Associated Merchandising Company ("AMC") was an international sourcing company that served multiple retailers. (Tr. 120:3-16.) AMC performed sourcing work for Target prior to 1998, when Target acquired AMC. AMC continued to provide sourcing services to Target and other retailers after its purchase. (Tr. 120:2-16, 147:12-16.)

D. <u>Formation of TBI</u>

9. At the time TBI was formed, Erica Street was an associate general counsel with Target. (Tr. 52:14-25.) During her nine years in the Target law department, Ms. Street gained experience in the management and protection of IP, as well as in state tax focusing on the nexus

between Target and the various states. (Tr. 52:14-53:11, 146:12-21.) She was responsible for the management of Target's IP assets. (Tr. 53:17-54:2.)

10. Ms. Street became TBI's first president. (Tr. 48:5-11.)

i. ***<u>Business Reasons for Forming TBI</u>***

11. In 1998, Target undertook an analysis to solve two business objectives: (1) how to place Target on a better footing with competitors such as Walmart from a tax perspective and (2) how to manage Target's IP. (Ex. P-189 at 5; Tr. 60:12-24, 147:21-148:24.) With the assistance of outside counsel and the accounting firm Ernst & Young, Target developed the concept of an IP holding company. That was the genesis of TBI. (Tr. 60:12-61:9.)

12. Target formed a cross-functional team to generate and analyze ideas that could improve the company's business and tax competitiveness. (Tr. Vol. 1 at 147:21-148:6, 180:7-181:8 (Street).) Only those initiatives that served a "true business purpose," in addition to having a beneficial tax aspect, were implemented. (Tr. Vol. 1 at 180:15-181:8 (Street).) The formation of TBI was one of the ideas that was ultimately implemented.

13. Target formed TBI as a wholly-owned subsidiary that would be devoted 100% of the time to brand management. (P-189 at 5-6; *see also* P-107.) TBI's business objectives fell into three broad categories: brand acquisition and management, brand compliance, and brand protection. (Tr. Vol. 1 at 70:2-71:2 (Street).) An overview prepared by Ms. Street shortly after TBI's creation states TBI was established to perform "brand management" through a "three-pronged approach": "Start Up Activities, Brand Acquisition and Management, and Brand Protection and Compliance." (Ex. P-189 at 7-8.) The overview also explains that TBI's structure and focus would result in an overall tax savings for Target. First, Target believed that because TBI had a U.S. presence only in Minnesota, neither its assets nor its royalty income would be

subject to tax in certain states. Second, Target believed the tax savings would be increased if at least 80 percent of TBI's payroll and property were located outside of the United States. (Tr. 144:23-145:20; Ex. P-189 at 13 (entitled Overview of Target Brands, Inc.).)

14. Before TBI was formed, Target had no centralized resources dedicated to the management, protection, and enhancement of its trademarks, patents, copyrights, and other IP assets. (Tr. Vol. 1 at 53:12-54:13 (Street).)

15. There were business risks and negative consequences to Target's failure to have centralized resources dedicated to the management, protection, and enhancement of its IP, particularly with respect to its Target stores and related private-label brands. (Tr. Vol. 1 at 53:12-56:6, 56:21-57:17 (Street).) For example, prior to TBI's existence, valuable trademarks such as Archer Farms were not even registered. (Tr. Vol. 1 at 62:22-63:16 (Street).) In addition, Target lost its ability to expand into Australia because, prior to TBI's existence, an unaffiliated copycat retailer named "Target Australia" had established operations using many of Target's trademarks (such as the Bullseye). (Tr. Vol. 1 at 63:17-65:11 (Street); P-158.)

16. Erica Street testified that "one of the impetuses for applying additional attention and time on the brand going forward was so that we could preserve our rights in our countries and not have a repeat of an Australia, where we would be foreclosed from operating in that country if we chose to go there unless we acquired Target Australia." (Tr. Vol. 1 at 64:23-65:4 (Street).)

17. The formation of TBI was motivated by, and served, legitimate business purposes aside from providing tax benefits. (Tr. Vol. 1 at 59:10-60:11, 63:17-65:11, 79:1-80:7, 180:15-181:8 (Street).) TBI's legitimate business purposes included having a dedicated group of people and resources who could focus on brand management, protection, enforcement, compliance,

training, and expansion of TBI's IP portfolio. (*Id.*) Those purposes also included, as discussed above, ensuring that TBI held rights in its IP in international jurisdictions to prevent any other Target Australia-type situations.

ii. <u>The Contribution and License Agreements</u>

18. Shortly after TBI's incorporation, Target and TBI executed a number of agreements: a Contribution Agreement, a License Agreement, a Revolving Note, and a Tax Sharing Agreement. (Tr. 149:22-150:13.)

19. Under the Contribution Agreement, Target contributed to TBI its then-existing intellectual property assets, which are listed on Schedule A to the Contribution Agreement. (Tr. Vol. 1 at 71:19-72:9 (Street); P-7.)

20. TBI and Target also entered into a License Agreement on the same date. (Ex. P-6.) Under the License Agreement, TBI granted Target the right to use its IP in connection with Target's sale of products in its retail operations. (Ex. P-6 at 3, § 1.) TBI also granted Target the exclusive right to use TBI's then-owned IP and any future IP in connection with the sale of Target's products nationwide. (Ex. P-6; Tr. 81:6-25.) The License Agreement included a provision automatically conveying any "Future Intellectual Property" to TBI and licensing such "Future Intellectual Property" assets to Target. (Ex. P-6 at 4, § 5.)

21. Both the Contribution Agreement and the License Agreement were executed in Minnesota and were governed by the laws of Minnesota. (Exs. P-6, P-7.)

22. Additionally, the License Agreement provided:

a. In exchange for the right to use the IP, Target agreed to pay TBI monthly "Percentage Royalty Payments" equal to the sum of a royalty rate multiplied by

"Target Net Sales." (Ex. P-6 ¶ 2(a); Tr. 82:17-84:6.) Target Net Sales were the "total net sales of [Target's] Target Stores Division." (Ex. P-6 ¶ (m).)

b. The Target Royalty Rate was determined by an independent appraisal of the value to TBI of the value of the use of the IP to Target. (Ex. P-6 ¶ 3.)

c. The Target Royalty Rate for the initial license year was 3% of Target's net sales. (Ex. P-6 ¶ (n).)

d. The goodwill of the IP belonged exclusively to TBI. (Ex. P-6 at 7.)

e. For subsequent years, the License Agreement established that an independent appraisal be conducted and a new Royalty Rate set on an annual basis. (Ex. P-6 at 3, § 3.)

23. TBI retained Ernst & Young to conduct the initial Transfer Pricing Analysis that was used to set the 3% Royalty Rate set forth in the License Agreement. (Ex. P-2; Tr. Vol. 1 at 82:1-83:12 (Street).) Ernst & Young was hired in subsequent years as well to conduct annual Transfer Pricing Analyses and recommend a Royalty Rate to TBI. (Tr. Vol. 1 at 85:24-87:12 (Street); Ex. P-114.) During the Years at Issue, the Royalty Rate for Target Stores and target.com sales varied between 3%-4%. (*See* Ex. P-114; *see also* Tr. Vol. 3 at 860:1-23 (Reilly).)

24. Expert testimony established that this Royalty Rate range was reasonable. (Tr. Vol. 3 at 860:13-861:13 (Reilly).)

25. It is standard for license agreements to establish a flat royalty rate, regardless of whether the licensor is only licensing IP to the licensee or whether the licensor is also performing IP-related services. (Tr. Vol. 3 at 897:24-898:17 (Reilly).) The provision of IP-related services is reflected in the royalty rate. (*Id.*) Ernst & Young's Transfer Pricing Analysis took into account

the business activities of TBI in setting the Royalty Rate. (Ex. P-2 at 30; Tr. Vol. 1 at 174:9-178:24 (Street).)

26. The Department does not challenge the appropriateness of the royalties paid to TBI, and its own auditor testified that they were valid royalty payments. (Tr. Vol. 3 at 632:16-24, 726:10-17, 728:12-729:1 (Tesfaye).)

27. The License Agreement was amended in February 2001. The method for determining the Royalty Rate paid to TBI remained materially the same. (Ex. P-32.)

28. By its express terms, the License Agreement did not establish an agency relationship between TBI and Target. (Exs. P-6 at 11, § 16(e); P-32 at 14, § 16(e); Tr. Vol. 1 at 91:19-92:22 (Street).)

iii. ***<u>Corporate Formalities and Business Operations</u>***

29. Legal corporate formalities were observed and followed in the formation of TBI, including the implementation of articles of incorporation and the establishment of a Board of Directors. (Ex. P-25; Tr. Vol. 1 at 65:21-70:1 (Street).)

30. TBI had two primary operation centers. It had its headquarters and IP legal department in Minneapolis, and its sourcing operation in Hong Kong. (Ex. P-107 at 1; Tr. 119:2-120:19.) TBI started with a few employees in Minneapolis and overseas, but grew rapidly. (Ex. P-107.) During each of the Years at Issue, TBI's total payroll was in the millions of dollars. (Exs. P-26 at 2; P-31 at 2; P-37 at 2; P-40 at 2; P-43 at 2; P-47 at 2; P-50 at 2; P-60 at 2; P-67 at 2; P-73 at 3; P-74 at 3.)

31. TBI's payroll reached its highest level in 2004, at $5,624,750. (Ex. P-47 at 2.)

32. TBI's employees were located in: Minneapolis, Minnesota; Kowloon, Hong Kong; Florence, Italy; Guangzhou, China; Shanghai, China; Guatemala City, Guatemala; Taipei, Taiwan; Singapore; New Delhi, India; and Mexico City, Mexico. (Ex. P-157 at 15; Tr. Vol. 1 at

113:2-20 (Street).) None of TBI's employees were located in Colorado. (Tr. Vol. 3 at 617:22-24, 637:19-23 (Tesfaye).) Ms. Street testified TBI had to be structured so that at least 80 percent of its assets were located outside of the United States in order to receive certain tax benefits. (Tr. 148:14-24.) She was responsible for creating yearly budgets for TBI to ensure that TBI always had at least 80 percent of its assets outside of the United States. (Tr. 149:3-7.)

33. In each of the Years at Issue, TBI's total expenses were in the millions of dollars (Tr. Vol. 2 at 399:2-402:1 (Romans); Ex. P-201 at 11.) In addition to payroll, TBI's expenses included rent, depreciation for owned assets, supplies, entertainment, travel, and other routine business expenses. (Tr. Vol. 2 at 399:22-400:5 (Romans).)

34. TBI's property consisted of offices (primarily in Minneapolis, Hong Kong, and Florence), for which TBI paid rent. TBI also owned tangible property such as computers and office supplies which were used by its employees to perform their business activities. (Tr. Vol. 1 at 128:12-129:4 (Street); *see also* Exs. P-26; P-31; P-37; P-40; P-43; P-47; P-50; P-60; P-67; P-73; P-74.) TBI had no tangible property in Colorado during the Years at Issue. (Tr. Vol. 3 at 636:16-18 (Tesfaye).)

35. While the majority of TBI's income was royalties paid to it by Target or other affiliates, TBI also received very limited income from unrelated third parties. (Tr. Vol. 1 at 171:14-173:1 (Street); Tr. Vol. 2 at 394:15-395:3 (Romans).)

36. There were a number of intercompany agreements between TBI and Target during the Years at Issue, including an Administrative Services Agreement, Tax Sharing Agreement, Revolving Note, and rent agreements. (Tr. Vol. 2 at 384:22-385:4 (Romans); Exs. P-4; P-11].

37. Under the Administrative Services Agreement, TBI paid Target to provide certain back-office services and functions such as tax, accounting, treasury, payroll administration, and human resources. (Tr. Vol. 2 at 385:7-386:21 (Romans); *see also* Tr. Vol. 1 at 207:7-25 (Ho).) Such arrangements are standard between parent corporations and wholly-owned subsidiaries. (Tr. Vol. 1 at 88:9-17 (Street).)

38. Under the Tax Sharing Agreement, Target prepared and filed all federal and state tax returns on behalf of TBI, and TBI in turn paid Target its portion of any federal or state tax liability owed. (Ex. P-4; Tr. Vol. 2 at 387:10-388:14 (Romans); *see also* Tr. Vol. 1 at 160:20-162:6 (Street).) The Tax Sharing Agreement, dated January 30, 1999, provided that Target was TBI's agent for the purpose of calculating, filing, and paying taxes on TBI's behalf and that TBI would reimburse Target for the amount of taxes paid. (Ex. P-4 ¶ 8.) Target also had sole discretion to contest, compromise, or settle any adjustment or deficiency. (Ex. P-4 ¶ 8.)

39. Under the Revolving Note, TBI loaned its available cash assets to Target on a daily basis and Target paid TBI interest on the loaned amounts. (Ex. P-11; Tr. Vol. 2 at 388:19-390:14 (Romans).) The balance of the Revolving Note was tracked by the financial reporting teams and reported on TBI's financial statements and consolidated balance sheets. (Tr. Vol. 2 at 391:7-396:6 (Romans); Ex. P-201.) Under the Revolving Note, dated March 1, 1999, Target promised to repay any recurring advances or loans made to it by TBI. (Ex. P-11 at 1.) Interest on the loans was due and payable twice a year. (Ex. P-11 at 2.)

40. Target did not separately pay TBI for activities performed outside of the United States, including services relating to the sourcing of products and brand compliance activities. (Tr. 159:7-160:1.) Ms. Street testified those activities were performed to protect TBI's assets.

(Tr. 181:20-182:7.) TBI also was not separately paid for any branding or marketing services. (Tr. 159:7-160:1.)

41. TBI's finances were tracked and reported through quarterly finance meetings, consolidated balance sheets, general ledgers, and federal tax filings, among other ways. (Ex. P-201; Tr. Vol. 2 at 292:25-294:19 (Lee).) For at least some of the Years at Issue, TBI also had its own employee in charge of financial planning, Mike Dumer. (Tr. Vol. 1 at 87:19-88:22 (Street).)

42. TBI paid dividends to Target on a regular basis.

E. <u>TBI's Business Activities During the Years at Issue</u>

43. TBI's personnel in Minneapolis served essentially as an IP-focused legal department, performing brand development and acquisition as well as brand management and protection functions. (Exs. D-45, P-24 (entitled Legal Aspects of Brand Management).)

44. Following TBI's formation, Ms. Street was tasked with getting the organization started. (Tr. Vol. 1 at 111:11-24 (Street).) A major part of TBI's startup activities involved Ms. Street going on a "goodwill tour" throughout the corporate organization to explain what TBI was, why it was formed, what its business activities would be, and how it would interact with the existing business organizations in the corporate family. (Tr. Vol. 1 at 111:11-24, 122:13-123:9, 144:22-145:23 (Street); Exs. P-189; P-107; P-157.)

45. TBI provided training to Target headquarters employees regarding a wide variety of IP issues. (*E.g.*, Exs. P-119, P-156, P-157; Tr. 249:24-251:6, 269:13-272:17; Lee Target 30(b)(6) Dep. 97:23-99:13.)

a. Those training sessions were not provided directly to Target store employees in Colorado, or elsewhere. However, those store employees did report up the organizational pyramid to executives in the Target Stores division in Minneapolis. (*See* Tr. 315:14-316:12.)

b. Store employees were ultimately the recipients of step-by-step instructions from Store Operations regarding, for example, a new brand. (Lee Target 30(b)(6) Dep. 107:22-110:8.)

i. <u>Brand Acquisition and Management</u>

46. TBI was responsible for the filing and management of all patent and trademark applications with the United States Patent and Trademark Office. In addition to filing initial applications, TBI was responsible for addressing any issues that arose, answering inquiries, providing supplemental information, proving use of trademarks, and related activities. (Tr. Vol. 1 at 74:14-76:21, 125:19-126:1 (Street).) Similarly, TBI was responsible for registering copyrights through the U.S. Copyright Office. (Tr. Vol. 1 at 77:1-19, 125:19-126:1 (Street).)

47. TBI worked to expand its IP portfolio beyond those assets that were originally contributed to it by Target in 1999. Among other things, TBI worked with Target business units such as merchandising and marketing to "identify[] gaps in merchandise assortment or marketing initiatives where perhaps a new brand should be introduced." (Tr. Vol. 1 at 79:4-14 (Street).) TBI expanded existing trademark, patent, and copyright registrations. (Tr. Vol. 1 at 79:15-19 (Street).) TBI also worked with Target advertising teams to expand awareness of the brands. (*Id.* at 79:20-80:7 (Street).)

48. In 1999, TBI implemented a new policy requiring incoming Target employees to sign a confidentiality and assignment of inventions agreement, to ensure that any IP developed by a Target employee would be transferred to and owned by TBI. (Tr. Vol. 1 at 137:16-138:12 (Street); Ex. P-17.)

49. Another business activity of TBI was to have its employees involved early in the process of developing new brands, trademarks, or other IP, with the specific objective of ensuring that new brands would be legally clearable and protectable. (Tr. Vol. 1 at 123:15-124:24, 185:19-186:4 (Street); Tr. Vol. 1 at 248:10-249:23 (Lee).)

50. Similarly, TBI worked to acquire domain names anytime a new brand was launched. (Tr. Vol. 1 at 266:10-21 (Lee).) TBI also worked to acquire domain names that were similar to, or misspellings of, Target's websites to ensure that consumers seeking to reach a Target website were not misdirected to websites that would be damaging to TBI's owned-brands and IP. (Tr. Vol. 1 at 266:22-267:11 (Lee).)

51. The reason for TBI being involved early in the process of developing new IP was "to develop strong owned brands at the company." (Tr. Vol. 1 at 249:7-8 (Lee).) Beginning in 2003 under Stephen Lee's leadership, TBI also launched an innovation procurement program to identify innovations occurring within Target that could be patented. (Tr. Vol. 1 at 236:21-237:15 (Lee).) The innovation procurement program was developed after Mr. Lee recognized that TBI and Target were under-protected in the patent arena, and involved TBI personnel meeting regularly with Target corporate personnel to identify the patentable innovations occurring within the corporation. (*Id.*) After a few years of the program, TBI had grown its patent portfolio from a single patent to more than one hundred issued and pending patents. By 2009, the number of issued and pending patents was closer to one thousand. (Tr. Vol. 1 at 239:4-240:15 (Lee).)

52. To ensure that it would be involved early in the IP-development process, TBI established multiple touchpoints with Target employees at corporate headquarters—including training sessions, internal intranet sites, and an email address (targetbrands@target.com) through which TBI could be contacted. (Tr. Vol. 1 at 249:24-251:6 (Lee).)

53. TBI was successful in greatly expanding its IP portfolio, as demonstrated by comparing the number of IP assets identified in the Contribution Agreement (Ex. P-7) with the lists of trademark, patent, copyright, and domain names that existed at the end of the Years at Issue. (Exs. P-93; P-104; P-111; P-112; *see also* Tr. Vol. 1 at 243:15-246:9, 266:3-267:11 (Lee).)

54. In addition to expanding its IP portfolio domestically, TBI undertook an effort to acquire trademark and other IP rights internationally to protect Target's ability to move into foreign jurisdictions. (Tr. Vol. 1 at 108:3-109:23 (Street); Ex. P-137.) This program began under Erica Street's leadership, and continued to grow and expand throughout the Years at Issue. (Tr. Vol. 2 at 281:5-21, 282:19-287:17 (Lee).)

55. TBI developed and drafted branding guidelines setting forth the rules that Target was required to follow in using certain of TBI's trademarks and corporate identity signatures, such as the Bullseye. (Exs. P-18; P-175; Tr. Vol. 1 at 94:7-102:1 (Street).) Such guidelines ensured consistent use of TBI's trademarks, which is critical to maintaining a trademark's value. (Tr. Vol. 1 at 98:3-22, 125:3-15 (Street).)

56. TBI was a "required approver" of any new marketing, advertising, or other branding program undertaken by Target. (Ex. P-48; Tr. Vol. 1 at 258:24-261:1 (Lee); Tr. Vol. 2 at 349:10-350:2 (Lee).) In that role, TBI was responsible for reviewing proposed marketing or advertisements and would "either grant approval, disallow approval, or say it had to be tweaked or say something had to be changed because it was not compliant or didn't follow one of the rules . . . ." (Tr. Vol. 1 at 260:11-261:1 (Lee).)

57. Target's approval process for new marketing and product ideas was generated by the "marketing pyramid." (*E.g.*, Exs. P-48, D-59 at 20-21; Tr. 247:7-248:23, 355:24-356:14; Lee TBI 30(b)(6) Dep. 43:24-44:20.) TBI was not responsible for the creation of new IP, which

came, for example, from the marketing pyramid for brands and trademarks. (Tr. 306:12-306:25, 307:6-12; Lee Target 30(b)(6) Dep. 62:25-63:17.)

58. Specifically with respect to the Marketing / Brand Project Approval Process (Ex. P-48), there were only two places where TBI was listed as a Required Approval; dozens of other approvals were needed from the marketing pyramid and Target corporate. (Tr. 308:25-310:6.)

59. TBI personnel also reviewed all Target Corporation advertisements, including those sent to Colorado consumers, to ensure that the use of the company's trademarks were consistent with an internally-approved style guide. (Ex. D-59 at 22; Tr. 349:10-350:16.)

60. TBI often said "no" to proposed uses of its trademarks by Target employees. (Tr. Vol. 1 at 106:14-108:2 (Street).) Erica Street testified that this frequently happened with respect to the creative teams at Target (such as marketing and merchandising) wanting to change the Bullseye's appearance in connection with holidays or other special events. (*Id.*)

61. As the owner and licensor of the IP, TBI had the authority to (and, in fact, did) refuse Target permission to use TBI's IP when the use would have been non-compliant with TBI's rules and directives. (Tr. Vol. 1 at 251:15-253:14 (Lee); Tr. Vol. 2 at 364:18-365:22 (Lee); Tr. Vol. 1 at 106:14-108:2 (Street).) Ensuring such authority, as owner and licensor of the IP, was one benefit to TBI being formed as a wholly-owned subsidiary. (Tr. Vol. 2 at 363:24-364:17 (Lee).) Mr. Lee testified that TBI's authority and ability to make decisions "independent of external business pressures" differentiated TBI from corporations that did not have a wholly-owned subsidiary which owned and managed their IP portfolio. (Tr. Vol. 2 at 367:3-22 (Lee).)

62. TBI also participated in the negotiation, drafting, and management of third-party license agreements with designers whose products would be carried exclusively in Target stores. (Tr. Vol. 2 at 288:2-290:12 (Lee); Ex. P-52.)

ii. ***Brand Protection***

63. TBI engaged in training and education of Target corporate employees on IP matters such as the proper usage of TBI's trademarks, copyrights, and patents, and the potential legal ramifications of failure to adhere to TBI's rules of use. The training occurred through in-person meetings and presentations, as well as through TBI materials being posted on corporate intranet sites. (Tr. Vol. 1 at 70:15-23, 93:15-94:6, 112:15-113:1, 134:16-135:6, 184:16-185:18 (Street); Tr. Vol. 1 at 269:22-272:3 (Lee); Tr. Vol. 2 at 290:13-292:3, 299:12-300:8 (Lee).)

64. TBI did not engage in any training of Target employees at the store level, nor did store-level employees have access to the intranet sites containing TBI's training materials. (Tr. Vol. 1 at 184:8-15 (Street); Tr. Vol. 2 at 292:4-11, 300:9-15, 301:3-10 (Lee).)

65. TBI also trained vendors that Target used to manufacture private-label brands. This training included describing what TBI was, the vendors' legal obligations with respect to TBI's IP, and how to protect the Target brand. (Ex. P-180; Tr. Vol. 1 at 268:13-269:4 (Lee).)

66. TBI implemented trademark-watch programs to ensure that neither domestic nor international third parties were using (or misusing) TBI's trademarks. (Tr. Vol. 1 at 126:10-25 (Street); Tr. Vol. 2 at 317:11-318:9, 322:13-15 (Lee).)

67. TBI undertook enforcement actions against parties that were infringing or potentially infringing on TBI's IP rights. (Tr. Vol. 1 at 127:4-9 (Street); Tr. Vol. 2 at 301:19-303:21 (Lee).) Such enforcement actions could involve simply sending inquiry letters and/or cease and desist letters, or could ripen into litigation that TBI would oversee and manage. (Tr. Vol. 1 at 128:3-11 (Street); Tr. Vol. 1 at 263:12-265:24, Tr. Vol. 2 at 301:19-303:21 (Lee).)

68. TBI retained outside counsel, often at Faegre & Benson, to send out trademark inquiry and cease-and-desist letters regarding potential infringement of TBI's IP. TBI identified four instances in which letters were written to companies or individuals located in Colorado and

resulted in negotiations with those Colorado businesses and/or counsel. (Exs. P-29, P-46, D-37; Lee TBI 30(b)(6) Dep. 35:7-40:7.)

69. In lieu of taking enforcement actions, TBI would at times purchase similar, competing trademarks to remove them from the market. (Tr. Vol. 1 at 127:12-24 (Street).)

70. TBI also developed Vendor Salvage and Resale Guidelines. (Ex. P-153.) The vendor salvage program ensured that "manufacturers who supplied branded products" to Target and which produced excess merchandise would liquidate that merchandise appropriately by removing marks and paying TBI a licensing fee. (Tr. Vol. 1 at 88:23-91:18 (Street); *see also* Tr. Vol. 1 at 199:6-200:7 (Ho).) The purpose of the program was to ensure that "any resale of goods that had any TBI intellectual property assets attached to them was done in a way that did not degrade or undercut the value of the brands." (Tr. Vol. 1 at 90:9-16 (Street).)

iii. Brand Compliance

71. TBI's compliance function included the work of its employees located in Hong Kong and Florence who were engaged in regional sourcing. (Tr. Vol. 1 at 114:3-22 (Street).) Regional sourcing involves identifying manufacturers and vendors within a multi-national region of the world (for example, Asia) which had the capability and capacity to produce products that satisfied Target's quality, business, and branding requirements. (Tr. Vol. 1 at 114:3-22, 116:8-117:5 (Street); Tr. Vol. 1 at 189:25-191:1 (Ho).)

72. Sourcing is the process of identifying, evaluating, and engaging product vendors and factories to create specific products. (Tr. 190:5-14.) There are at least two types of sourcing: regional sourcing and local sourcing. Local sourcing means sourcing from a single country within a region. (Tr. 192:4-11.) Regional sourcing means sourcing from a multi-country geographic area. (Tr. 192:8-16.)

73. TBI's overseas employees also engaged in social compliance audits, which involved unannounced factory inspections aimed at ensuring that the working conditions were appropriate and that safety standards were being met. (Tr. Vol. 1 at 114:23-115:2, 118:2-6 (Street).) Social compliance was "[c]ritically important" to TBI, particularly because in the mid-'90s other retail manufacturers were found to be employing child labor and allowing substandard working conditions. TBI did not want itself or Target associated with any such overseas manufacturer. (Tr. Vol. 1 at 118:7-119:1 (Street).)

74. TBI also engaged in spot-checking of manufactured products to ensure that labeling and packaging was correct, and that any vendor engaging in liquidation of product was doing so appropriately under TBI's guidelines. (Tr. Vol. 1 at 115:2-10 (Street).)

75. Prior to the creation of TBI, Associated Merchandising Corporation ("AMC") provided product-sourcing services to Target. (Tr. 120:11-16.) Upon formation of TBI, the AMC employees who had been engaged in regional sourcing for Target-owned brands became TBI employees as part of the corporate restructuring. (Tr. Vol. 1 at 196:4-19 (Ho); Exs. P-9, P-10.) In February 1999, TBI hired employees who worked on AMC's sourcing teams in Hong Kong to staff TBI's new Hong Kong office. (Tr. 120:17-122:6, 142:1-4.)

76. AMC terminated Cynthia Ho's employment effective March 1, 1999. (Ex. P-9.) Ms. Ho was a regional sourcing director for AMC at the time. (*Id.*) Effective the same day, TBI hired Ms. Ho to be a TBI regional sourcing director. (Ex. P-10.)

77. Ms. Street testified that AMC employees were hired because TBI needed sufficient foreign employees to be considered an "80/20" company (a status that could result in preferential tax treatment) and because of the employee's experience. (Tr. Vol. 1 at 142:1-20 (Street).)

78. Regional sourcing was moved to TBI to enable the employees "to build a robust sourcing strategy across the world" for TBI-owned brands, to create a dedicated team focused solely on TBI-branded products, and to protect Target's proprietary information better than could have occurred had regional sourcing remained part of AMC, given that AMC had other retailer clients. (Tr. Vol. 1 at 201:5-205:2 (Ho).)

79. TBI's product-sourcing efforts involved both TBI and AMC employees. (Tr. 197:8-198:12.) AMC's local-sourcing employees were responsible for identifying and recommending to TBI vendors and manufacturers in their respective countries that could meet Target's needs. (Tr. 197:16-24, 221:10-16.) TBI would then conduct additional research into those candidates before recommending them for approval as vendors for Target. (Tr. 197:16-198:5.) After a vendor was approved, AMC would oversee the vendor's work. (Tr. 198:5-7.) TBI would be brought in if the vendor experienced problems that could impact product deliveries. (Tr. 198:9-12.) If a particular product line was overproduced or discontinued, AMC and TBI would work with the manufacturer to ensure that the manufacturer followed Target's guidelines for disposal of any remaining inventory the manufacturer had in its possession. (Tr. 199:8-200:3.)

80. TBI was involved in issue resolution because "the regional sourcing teams are always thinking about protecting the brand and mitigating the risk of Target," and because TBI's regional expertise allowed it to provide resources and solutions beyond that available locally. (Tr. Vol. 1 at 198:13-199:19 (Ho).)

81. There was a close relationship between TBI and AMC. AMC provided administrative services to TBI, including hiring employees for TBI, for which TBI made payments to AMC. (Tr. 206:13-207:25.) At least as late as 2002 and while she was TBI's

regional vice president, Ms. Ho represented herself as being part of both TBI and AMC as evidenced by the information on the business cards she would provide third-parties. (Ex. P-160; Tr. 224:15-227:2.) She also used an AMC email address despite her position with TBI. (Tr. 224:15-227:2.)

82. During the Years at Issue, Erica Street and other Minneapolis TBI employees would travel to TBI's overseas locations to both participate in factory inspections and to train TBI's overseas employees on IP and brand-related issues. (Tr. Vol. 1 at 115:11-116:7 (Street); Tr. Vol. 1 at 214:2-215:11, 229:23-231:6 (Ho).)

83. TBI stopped managing sourcing for Target in 2010. (Tr. 216:7-11.) Sourcing is now performed by Target Sourcing Services ("TSS"), which is also a subsidiary of Target. (Tr. 215:25-216:3.) It appears that some former TBI employees are now TSS employees. (*See* Tr. 187:25-188:8.)

84. The Court finds that including foreign employees within TBI was intended, at least in part, to reduce state income taxes. The Court reaches this conclusion based on the following facts:

a. Target intended TBI to be a "tax advantageous entity." (Tr. 142:13-14; Ex. D-5 at 3.)

b. The inclusion of foreign employees in TBI's structure was intended to obtain this tax-advantaged status by making TBI an 80/20 company. (Tr. 142:13-17.)

c. Status as an 80/20 company can impart certain state income tax benefits.

d. Sourcing was not consolidated within TBI. Sourcing was a joint effort between TBI and AMC.

85. The Court also finds that TBI's business activities were aimed at building, maintaining, and protecting strong owned-brands and other IP. TBI was successful in accomplishing those goals. TBI's business activities generated more valuable IP, which contributed positively to Target's net sales and TBI's resulting royalty income. (*See* Tr. Vol. 3 at 862:12-863:9, 866:9-869:5 (Reilly).)

F. **Target's Retail Operations and Use of TBI's Intellectual Property**

86. Prior to TBI's creation, Target owned all of the IP listed on pages 4-15 of Exhibit P-7. This included trademarks for the name "Target" and the Target bullseye design. (*See, e.g.*, Ex. P-7 at 5 (listing a mark for "Design Only (Bullseye)"), 9-10 (Target trademarks).) Some of these trademarks had been in existence since the 1960s. (*See* Ex. P-7 at 9-10.)

87. The IP transferred to TBI under the Contribution Agreement and then licensed back to Target in the Licensing Agreement was used by Target prior to TBI's creation. (*See* Ex. P-6 ¶ 6(a) (allowing Target to continue to use the IP "in the same manner and to the same extent as it is currently being used").) Thus, although the owner of the IP changed from Target to TBI, Target continued using the IP it contributed to TBI without interruption.

88. During the Years at Issue, Target operated a number of stores in Colorado. (*See* Tr. 1064:10-1065:4, 1066:19-22.) Target generated substantial revenue from its Colorado stores. For example, in tax year 2005, Target generated over $1 billion in Colorado sales, which was approximately 2.2212% of Target's total sales revenue for that year. (Ex. P-64 at 30.)

89. Given the close relationship between TBI and Target, Target's continuing use of the IP before and after the License Agreement, and the presence of Target stores in Colorado at the time of the License Agreement, TBI knew that its IP would be used by Target in Colorado and that TBI would receive royalties based on Target's sales in Colorado.

90. Every Target store in Colorado used TBI's IP during the Years at Issue. (Ex. D-115 at 4.)

a. Each of Target's Colorado stores used the "Target" trademark and the Target bullseye. (*Id.*) For example, each Colorado Target store had a sign displaying one or both of these TBI-owned marks. (Tr. 1070:11-1072:10; *see, e.g.*, Ex. D-98 at 1, 4.)

b. The purpose of displaying the TBI-owned "Target" name and bullseye outside of a store was to alert potential customers to the presence of a Target store so they would go there to shop, thereby generating revenue for TBI. (Tr. 1072:18-1073:3 (regarding purpose of sign); *see, e.g.*, Ex. P-6 ¶ 2(a) (calculating TBI's royalties based on Target's net retail sales).)

c. During the Years at Issue, TBI-owned trademarks appeared on all types of products in Target's stores, including sporting goods, home furnishings, clothing, and pet supplies. (Tr. 1077:3-1082:24 (discussing trademarks listed in Ex. D-115 at 4-6); Ex. D-115 at 4-6.)

d. The purpose of displaying TBI-owned trademarks on products in Target's Colorado stores also was to encourage consumers to purchase those products, which generated revenue for TBI. (*See, e.g.*, Tr. 1080:11-1081:2.)

91. Each of the in-state Target employees was considered a "brand manager." (Tr. 357:1-19.)

a. At the store level, the Store Team Leader is responsible for maintaining the general reputation of the Target brand, which contributes to guest goodwill: "the overall brand reputation, store by store, that we would have a high quality shopping experience for the guest." (Target 30(b)(6) Dep. at 117:19-118:6.)

b. Having a high functioning, productive, friendly store that is a repeatable experience as a customer goes from store to store contributes to the Target brand, and in turn contributes to the success of the corporate family, and maintains and enhances the value of TBI's IP. (Target 30(b)(6) Dep. at 118:13-119:5.)

c. The Department's marketing expert, Professor Donald Lichtenstein, confirmed the importance of these store employee functions. In his opinion, Target's Colorado store employees are a significant contributor to the goodwill and brand equity of the Target brand. Professor Lichtenstein explained that "brand image" "is based on the strong, favorable, and unique associations with the brand that a consumer has in mind. And for the retail store, the front-line employees would be a significant contributor (sic) to the brand image and brand equity." (Tr. 1021:5-1023:13.)

d. The efforts of the Colorado store employees, in turn, affect the royalties that TBI receives because the employees' work increases Target's net sales: "[T]he behavior of Colorado store employees will positively affect the brand equity, you know, the associations consumers have in their minds with the brand, which will lead to future sales." (Tr. 1025:5-1025:9.)

92. These in-store employees impact the amount of royalties TBI received because TBI's royalties were based on Target's net retail sales. (Tr. 1021:9-1022:20; *see, e.g.*, Ex. P-6 ¶ 2(a) (regarding royalty payments).)

93. Target relied on the benefits the State of Colorado provided for the operation of its retail stores as demonstrated by the following facts:

a. Inventory was delivered to Target's Colorado stores using Colorado's roads. (Tr. 1069:2-5.)

b. Target store employees used Colorado roads and public transportation to get to work. (Tr. 1068:10-22.)

c. Target's customers used Colorado's roads to go to Target's Colorado stores and make their purchases. (Tr. 1068:23-1069:1.)

94. Target further relied on the benefits the State of Colorado provided by enacting policies for its stores that demonstrated an intent to use public services, including the following:

a. Target's policy to combat shoplifting included calling the police. (Tr. 1067:2-17.)

b. Target's policy for dealing with fires included calling the fire department. (Tr. 1067:2-10, 1067:24-1068:1.)

c. Target's policy for dealing with medical emergencies included calling "911." (Tr. 1067:2-10, 1068:2-9.)

95. TBI similarly benefited from these services given TBI's reliance on Target's retail stores to generate TBI's royalty income. Obviously, if Target's employees had not used Colorado's roads and public transportation systems to get to work, there would have been no one to process the in-store sales that generated TBI's royalty income. Similarly, if delivery trucks had not been able to use Colorado's roads, there would have been no inventory to sell to customers and thus, no royalty income to TBI.

96. The Court is unable to place a monetary value on the impact TBI had on Target's retail operations, even though:

a. TBI's retained expert, Robert Reilly, testified that Target enjoyed appreciably better performance than a peer group of retailers Mr. Reilly selected.

b. Mr. Reilly attributed at least some of that improved performance to TBI and the IP that was available to Target through TBI. (Tr. 866:13-869:5.)

97. However, Mr. Reilly's testimony was lacking in several respects:

a. Mr. Reilly failed to examine the period prior to the existence of TBI. (Tr. 899:1-900:23.) Thus, the Court cannot tell if the improved performance Target enjoyed compared to the peer group pre-dated TBI's existence and could be attributable to factors unrelated to TBI.

b. Mr. Reilly consulted Target employees regarding any material differences between Target and the peer group, and those individuals told him that the difference between Target and the peer group was Target's brand. (Tr. 902:21-903:24.) Mr. Reilly, in turn, interpreted the reference to Target's brand to mean TBI. (Tr. 903:12-24.) But as both Ms. Street and Professor Lichtenstein testified, a brand's value has many components. (Tr. 166:17-168:3, 1021:9-1022:20.) A brand's strength relies on consumer perception of the brand, which is developed in large part on the customer interactions that occur at the store level. (Tr. 1021:9-1022:9.) Here, those interactions occur in the stores in Colorado between Target—not TBI—employees and the customers. (*See* Tr. 166:17-168:3.) Target explicitly recognized the importance of those interactions to Target's brand when Target's former chief executive officer designated every person in the Target organization a "brand manager." (*See* Tr. 357:1-19.)

c. One of the bases for Mr. Reilly's conclusions was that there were no material differences between Target and the peer group, other than the strong IP to which Target had access through TBI. (Tr. 883:12-884:16.) However:

i. Mr. Reilly could not recall if any of the peer group companies, other than Walmart, had an internet shopping presence during the Years at Issue. (Tr. 887:19-25.) Target has had an internet shopping presence during all of the Years at Issue. (Tr. 888:1-3.)

ii. Most of the peer group companies had earnings that were substantially less than those of Target. (Tr. 886:7-13.)

iii. Mr. Reilly could not recall if Family Dollar had a proprietary credit card. (Tr. 886:21-887:2.) Target has offered a proprietary credit card since at least 1995, and Target believes that its credit card helps to drive sales. (Tr. 887:3-18.)

iv. Mr. Reilly did not consider a substantially different amount of advertising expenses and the use of different media for advertisements between Target and one of the peer group companies. (Tr. 888:4-891:15.)

98. Additionally, Target is responsible for developing the underlying innovations that later became TBI's IP. (Tr. 248:10-249:23, 306:19-307:12, 355:24-356:14.) The Court finds that it is unreasonable to attribute to TBI the full value of the IP to which Target had access through TBI when Target was responsible for creating the underlying innovations. Moreover, Mr. Reilly did not separately value the services TBI provided and the IP that TBI licensed to Target, making it impossible to tell what value was generated by Target's innovations and what value was

generated by the services TBI performed. (Tr. 897:24-898:4.) Therefore, the Court finds that it has insufficient information to monetarily value TBI's contributions to Target's retail operations.

G. The Flow of Money between TBI and Target

99. Pursuant to the License Agreement, Target paid TBI royalties in the amount of $17.9 billion between February 1999 and January 2010. (TGT 30(b)(6) Dep. 12:5-11; Ex. D-95.) For each tax year, the payments were as follows (these figures come from Ex. D-95):

Tax Year	1999	2000	2001	2002
Royalty	$819,273,902	$1,038,753,422	$1,318,662,166	$1,392,371,166

Tax Year	2003	2004	2005	2006
Royalty	$1,386,107,638	$1,613,402,637	$1,790,725,522	$1,998,253,609

Tax Year	2007	2008	2009	Total
Royalty	$2,153,011,428	$2,205,912,783	$2,232,417,756	$17,948,892,029

100. Over this period, based on the percentage of Target's sales that occurred in Colorado, TBI received over $400 million in royalty income attributable to purchases by Colorado consumers in Target stores.

101. Target has not provided the Court with a calculation of the royalties it paid to TBI by state. These figures are derived from the tax calculations the Department provided. The amount of tax is determined by multiplying TBI's Colorado-source income by the applicable tax rate. Thus, by reversing the calculation and dividing the amount of tax assessed against TBI by the applicable tax rate, it is possible to determine the amount of income sourced to Colorado. (*See* Ex. D-112 at 2); C.R.S. § 39-22-301(1)(d)(I)(H), (I) (providing tax rates for the Years at Issue). TBI's income attributable to Colorado, according to the Department, is: $20,323,536 (1999); $25,207,105 (2000); $30,554,449 (2001); $31,657,300 (2002); $32,141,036 (2003); $43,744,881 (2004); $39,985,161 (2005), $47,175,593 (2006); $51,645,118 (2007); $53,162,116

(2008); and $54,286,695 (2009). Some of TBI's income was not royalty income, but TBI has not provided the Court with an accounting of the specific amounts that were not royalties nor has it asserted any claims based on the inclusion of non-royalty income. Based on the testimony and TBI's bank statements, the overwhelming majority of TBI's income was from royalties.

102. The royalty payments were calculated on a monthly basis by multiplying the net sales by a royalty rate. (Tr. 151:22-152:13; Ex. P-6 ¶ 2; TGT 30(b)(6) Dep. 18:12-25.)

103. The royalty rate was determined over the course of the Years at Issue based on the transfer pricing reports completed by Ernst & Young.

104. Because TBI's royalty payments were calculated based on Target's net sales, TBI's royalty income increased as Target's net sales increased. (Tr. 152:14-21.)

105. Despite substantial royalty payments, Target's net cash flow remained largely unchanged. TBI immediately returned virtually all of the royalty payments in the form of loans under the Revolving Note or dividend payments to Target as TBI's sole shareholder. (TGT 30(b)(6) Dep. 12:12-14:3, 14:18-24.)

106. There was a pattern through the Years at Issue: each month TBI's corporate checking account had a beginning balance of zero and an ending balance of zero. (Ex. D-4; Tr. 467:24-468:4.) During each month, Target would deposit one or more royalty payments into the account. In the same month—and usually on the same day—TBI would loan the funds back to Target. (Ex. D-4; Tr. 464:4-13, 465:6-466:23, 475:11-16.)

107. Target also paid interest on the loaned amount periodically. Those funds were also immediately loaned to Target. (Tr. 475:18-20.)

108. Periodically, Target made payments to reduce the amount of the loan; TBI would then issue dividends in virtually the same amount to Target. (Tr. 475:25-476:20.)

109. As an example, TBI's Business Statement for August 2000 shows two deposits by Target. One deposit of $29,354,296 was made on August 1; on the same day, the amount was transferred back to Target as a dividend payment. On August 23, a deposit of $4,023,477 was made in TBI's bank account from Target and the same amount was then loaned back to Target on the same day. (Ex. D-4 at 47.) Similarly, in May 2001, Target deposited $720,773,527 into TBI's corporate checking account. TBI transferred $720,714,843 back to Target by the end of the month. The difference of approximately $58,000 went to TBI operating expenses. (Ex. D-4 at 62-63.)

H. <u>The Tax Benefit Created by TBI</u>

110. As a result of TBI's status as a separate, 80/20 company, Target substantially reduced its overall tax burden. Ms. Street testified Target would not have realized any tax benefits if management of the IP were placed in a division of Target. (Tr. 181:9-15.)

111. The tax benefit TBI provided to Target depended on its status as an 80/20 corporation, as explained below.

a. On its federal income tax return, Target deducted the royalties that it paid to TBI from its income, which resulted in a lower federal taxable income for Target. (*See* Tr. 1010:12-22.)

b. This lower federal taxable income impacted the amount of income apportioned to Colorado when Target filed its Colorado corporate income tax returns. This is because the income that is subject to apportionment is Target's "net income," which is statutorily defined as Target's federal taxable income subject to certain adjustments not at issue here. § 39-22-304. As a result, changes in federal taxable income trickle down to impact Colorado net income and, ultimately, a company's Colorado income tax obligation. (*See id.*)

c. If TBI were included in Target's combined Colorado income tax return, the deduction that Target enjoys at the federal level (and that eventually impacts its Colorado tax obligation) would be offset by TBI's income. (*See* Tr. 743:17-744:6.)

d. By excluding TBI from Target's combined income tax return, Target removed the otherwise offsetting income that TBI would add to Target's net income on the combined return.

112. The removal of TBI's income from Target's combined return created a substantial tax benefit for Target, as demonstrated by Target's taxes for tax year 2002. At the federal level, Target Corporation and all of its subsidiaries had $1,588,215,074 in federal taxable income. (Ex. P-155 at 5.)

113. To calculate Colorado net income, the income from certain companies that could not be included in the Colorado combined return was excluded. (Ex. P-155 at 5.) These exclusions reduced the income that could be subject to apportionment from $1,588,215,074 to a loss of $248,288,779. (Ex. P-155 at 5.) Because Target experienced a loss, it owed no Colorado income tax for tax year 2002.

114. TBI (under its former name, Dayton Hudson Brands, Inc.) was one of those excluded companies. (Ex. P-155 at 10-11.) TBI had federal taxable income of $1,334,721,287 for that year. (*Id.*)

115. Had TBI been included in Target's combined return, the amount of Target's income subject to apportionment would have been $1,079,549,142 instead of negative $255,172,145. (*See* Ex. P-155 at 5 (-$255,172,145 + $1,334,721,287 = $1,079,549,142).)

116. This would have resulted in positive income of $24,455,026.71 being apportioned to Colorado instead of a loss of $5,780,303. (*See Id.* ($1,079,549,142 x 2.2653% (the apportionment factor) = $24,455,026.71).)

117. After applying Colorado's corporate income tax rate, Target would have owed $1,132,267.74 to Colorado. (*See Id.* ($24,455,026.71 x 4.63% = $1,132,267.74). Instead, Target paid no income taxes for tax year 2002. (*Id.*) Thus, for only one tax year, Target saved $1,132,267.74 by excluding TBI from Target's combined Colorado income tax return.

I. <u>The Department's Audits and Assessments of TBI</u>

i. <u>*Department Audit of Target Corp. and Subsidiaries for Tax Years 1994–2001 (the 2003 audit)*</u>

118. In 2003, the Department conducted an audit of Target Corp. and Subsidiaries for tax years 1994-2001. The 2003 audit was conducted by Mr. David Kennedy. (Exs. P-41, P-135, P-155; Tr. Vol. 2 at 420:2-422:11 (Romans); Tr. Vol. 4 at 929:21-930:3, 941:21-24 (Kennedy).) Hereafter, this audit will be referred to as the "2003 audit."

119. The procedure that Mr. Kennedy followed for an audit was to verify the items on the Colorado return, starting with the federal taxable income that is brought forward to the Colorado return. Where a corporation has a large number of subsidiaries, the auditors would verify that the corporation's consolidating schedules included only companies that were combinable under Colorado statutes. Consolidating schedules are the supporting schedules used to disaggregate the total amounts reported on the federal return among a corporation's subsidiaries. (Tr. 932:6-24.)

120. The purpose of the 2003 Target Audit was to verify the combined returns that Target filed with the State of Colorado. (Tr. 932:2-5.) During the course of the 2003 audit, the Department observed that some of Target's subsidiaries had not been included in the Colorado combined returns, and that those subsidiaries had not filed separate company Colorado returns of their own. (Tr. Vol. 4 at 933:23-934:5 (Kennedy).)

121. The Department's Audit Selection and Tracking unit noted that Target excluded several subsidiaries that appeared to be combinable and should have been included. (Ex. P-135 at 2.)

122. Significantly, the Audit Selection and Tracking unit referenced the *Kmart Properties, Inc. v. New Mexico Revenue Department* case as precedent for combining companies that Target had excluded. (Ex. P-135 at 2.)

a. Mr. Kennedy has no recollection of having read the *Kmart* case. (Tr. 939:12-14.)

b. Mr. Kennedy is now aware that *Kmart* is an economic nexus case, but he does not recall anything about it from 2003 when he performed the Target Audit. (Tr. 960:12-17.)

123. Among the subsidiaries that Target excluded were two financial organizations that had activity in and were doing business in Colorado. (Tr. 933:23-934:18.) Colorado took the position that the exclusion of financial organizations in § 24-60-1301(IV)(1)(d) & (2) is not an exclusion from filing or from combination; rather it is an exclusion from using the regular three-factor apportionment formula to determine Colorado taxable income. Instead, financial organizations must use the Special Regulations for Financial Institutions to apportion income. (Ex. P-135 at 3.)

124. At the time of the 2003 audit, the Department was aware of TBI because it was disclosed on the "Affiliations Schedules" that were filed with Target's Colorado combined returns. (Ex. D-22, pp. 4, 8, 12; Tr. Vol. 4 at 947:20-948:21, 949:5-950:14, 953:25-954:21 (Kennedy).)

125. With respect to TBI specifically, because it began operations in 1999, it was listed on Target's Affiliations Schedules for tax years 1999, 2000, and 2001 and its principal business activities were described as "brand name promotion and protection." (Ex. D-22, pp. 4, 8, 12; Tr. Vol. 4 at 947:20-948:21, 949:5-950:2, 963:22-25 (Kennedy).)

126. At the time of the 2003 audit, it was the Department's practice when doing audits to look at both 2-year companies and 80/20 companies to determine if they were "doing business in Colorado" and had to file separate company returns on their own. (Tr. Vol. 4 at 973:16-20 (Kennedy).)

127. Under Colorado's corporate income tax statute, a company cannot be combined with its parent unless it had been part of the parent's organization for more than two years. *See* § 39-22-303(11)(a). The auditors would eliminate companies that were newly acquired or newly formed. The two-year combination issue came up frequently when Mr. Kennedy was auditing taxpayers with subsidiaries. (Tr. 932:25-933:22.)

128. The Department issued assessments against Target and its two financial organization subsidiaries: Dayton Hudson Investment Corporation ("DHIC") and Dayton Hudson Receivables Corporation ("DHRC"). (Ex. P-42; Tr. 961:9-18.)

129. During the 2003 audit, the Department's auditors discussed TBI, DHIC and DHRC with representatives of Target and indicated that the Department was "considering each of the excluded entities." (Ex. P-41 at 2.) The Department had authority to audit these

subsidiaries in connection with its audit of “Target Corp. and Subsidiaries.” (Tr. Vol. 3 at 593:19-594:24 (Tesfaye).)

130. The Department confirmed that under the 2-year rule, DHRC could not be included in the Target Colorado combined group for tax years 1995 and 1996, and that DHIC could not be combined for tax years 1994 and 1995. (Exs. P-41; P-42 at 5, 16; P-155 at 3.)

131. The Department analyzed the activities of both DHRC and DHIC within the statues and regulations regarding “doing business in Colorado” and also performed a nexus analysis for each entity. (Exs. P-42 at 5, 16; P-135 at 3; Tr. Vol. 4 at 964:22-966:20, 969:9-23 (Kennedy).)

132. Even though the financial subsidiaries could not be combined because of the 2-year rule, the Department looked specifically at whether DHRC and DHIC were “doing business in Colorado” and concluded that they were. (Ex. P-42; Tr. Vol. 4 at 950:23–951:9, 964:22-966:20, 969:9-23 (Kennedy).)

133. Having concluded that DHRC and DHIC were both doing business in Colorado and had income from Colorado sources, the Department issued separate assessments to each company. DHRC and DHIC paid these assessments without protest. (Ex. P-42; Tr. Vol. 4 at 950:23–951:9, 964:22–969:23 (Kennedy).)

134. For years in which the financial subsidiaries were combinable, the Department determined taxable income for the combined group by apportioning the incomes of the regular corporations in the group using the standard three-factor formula and apportioning the incomes of financial organizations in the group using the Department’s Special Regulation for Financial Institutions. Then, the two income streams apportioned to Colorado were added together to yield Colorado taxable income for the Target combined group. (Ex. P-135 at 3.)

135. During the course of the 2003 audit, the Department also had conversations with representatives of Target regarding TBI, including whether TBI should be part of the Target combined group. (Ex. P-41 at 2; Tr. Vol. 4 at 955:1-23 (Kennedy).)

136. During the 2003 audit, the Department was made aware of TBI's income, property, and payroll for tax years 1999, 2000, and 2001. TBI's income, property, and payroll figures were also identified specifically by the Department's auditor within the work papers that resulted from the 2003 audit. (Ex. P-155 at 10-11, 31, 33-34, 38-39, 42-43; Tr. Vol. 2 at 425:23-435:18 (Romans); Tr. Vol. 4 at 963:14-21 (Kennedy).)

137. TBI was not part of the Target Colorado combined group because it was an 80/20 company. During the 2003 audit, the Department confirmed TBI's 80/20 status. In making the 80/20 determination, the Department respected TBI's separate property and payroll. (Ex. P-135 at 2; Tr. Vol. 4 at 956:9-957:15, 961:22-25 (Kennedy).)

138. Having determined that TBI was an 80/20 company, the next analysis would be whether TBI was "doing business in Colorado." TBI would have a Colorado income tax return filing requirement if it was "doing business in Colorado." (Tr. Vol. 4 at 972:23–973:2, 973:16-20 (Kennedy).)

139. Mr. Kennedy testified with respect to TBI, "they weren't combinable with the parent, and there was no indication that, like the financial companies, that they [TBI] needed to file a Colorado return." (Tr. Vol. 4 at 944:7-17, 962:4-9 (Kennedy).)

140. The Department did not issue an assessment against TBI as a result of the 2003 Target Audit. (Tr. 961:19-25.)

141. Mr. Kennedy testified that he did not audit TBI during the 2003 Target Audit because it was an 80/20 company and thus not combinable with Target under Colorado law. (Tr.

943:1-7.) He did not assign TBI an audit tracking number because it was not combinable and, unlike the financial organizations, there was no indication that TBI needed to file its own Colorado return. (Tr. 944:7-17.)

a. Target's taxpayer contact, Bob Jacoby, told the Department's auditors that TBI was an 80/20 company. (Tr. 935:16-939:8; Ex. P-41 at 2.)

b. Mr. Kennedy testified that his practice would have been to trace the property and payroll of an 80/20 company to the consolidation schedules prepared by the taxpayer, but would not go beyond those schedules to determine whether it was appropriately designated an 80/20 company. (Tr. 974:2-20, 943:8-22.)

142. The audit narrative of the 2003 audit further confirmed that the Department did not believe that TBI had any Colorado activity. The audit narrative indicates "[w]e accepted numerators as filed because the subs [subsidiaries] we included and excluded had no numerator (Colorado) activity." (Ex. P-135 at 5.)

143. Following the 2003 audit, the Department also issued an assessment to Target, which Target paid without protest on September 18, 2003. (Ex. P-42.)

144. The Department did not instruct TBI that it needed to file a separate company return with Colorado for tax years 1999, 2000, 2001 or for any future tax year. (Tr. Vol. 2 at 425:11-16 (Romans); Tr. Vol. 4 at 961:19-962:9 (Kennedy).)

145. The Court finds that the 2003 audit for tax years 1999, 2000, and 2001 included TBI. (Tr. Vol. 4 at 944:7-17 (Kennedy).) It is undisputed that for the remaining Years at Issue, TBI continued to be excluded from the combined return of Target Corp. and Subsidiaries and did not file stand-alone returns.

146. If, during the 2003 audit, the Department believed that the royalty paid to TBI by Target had been improper or abusive, it could have addressed that concern through an adjustment to Target's gross income or deductions. § 39-22-303(6); (Tr. Vol. 3 at 770:18-771:21 (Pomp).) The Department did not do so. The Department did not disallow or adjust Target's royalty expense deduction nor did the Department find that Target had engaged in any abuse. (Tr. Vol. 4 at 964:5-21 (Kennedy).)

ii. MTC Audit of TBI for Tax Years 2002–2004

147. In July 2007, the Department issued Audit Adjustments for Tax Years 2002-2004. (Ex. P-64.) Those Audit Adjustments were issued based upon audit recommendations made by members of the Joint Audit Program of the Multistate Tax Commission ("MTC"). (*Id.* at 2; Tr. 979:21-980:13, 1011:24-1013:5.)

148. The MTC is an intergovernmental agency that performs, among other things, joint audits on behalf of member states. (Tr. Vol. 4 at 977:21-24, 978:21-979:8 (Felix).)

149. Colorado was a member of the MTC's Joint Audit Program. Each state in the program decides whether to participate in a given MTC joint audit and signs an audit authorization when it wants to participate in an audit that the MTC is performing. States do not pay to participate in a particular audit, but rather pay annual dues to the MTC. (Tr. 978:21-979:20.)

150. When performing an audit, the MTC acts as an agent of the state for which it is conducting the audit. The MTC does not dictate audit decisions to participating states. Rather, the MTC auditors make recommendations, which the states may choose to accept or reject. (Tr. Vol. 4 at 978:21-979:5, 985:1-5, 995:19-22 (Felix).)

151. The MTC audited Target and its subsidiaries. The MTC audit of TBI arose during the course of the MTC's audit of the Target Corp. and Subsidiaries group for the same tax years (2002-2004). The MTC had authority to audit TBI because, as a subsidiary of Target, TBI was within the scope of the audit engagement letter issued to Target Corp. and Subsidiaries. (Tr. Vol. 4 at 979:21-23, 980:20-23, 997:13-18 (Felix).)

152. At the time of the MTC audit, the MTC had 21 member states, including Colorado. Of the 21 member states, 12 participated in the Target Corp. and Subsidiaries audit, including Colorado. (Ex. P-59 at 4-5; Tr. Vol. 4 at 979:6-8, 980:17-19, 995:5-18, 997:4-8, 998:15-19 (Felix).)

153. Of the 12 states which participated in the MTC's audit of Target Corp. and Subsidiaries, only 4 elected to audit TBI. As a result, the MTC audited TBI on behalf of Arkansas, Colorado, New Mexico and West Virginia. (Tr. Vol. 4 at 1002:18–1003:1 (Felix).)

154. During the course of the MTC's audit of TBI, the auditor requested and received information regarding TBI and its business activities. Specifically, the MTC asked for and received the License Agreement, apportionment information, and documents containing descriptions of various business activities carried on by TBI in Minnesota, Hong Kong, and other foreign locations. (Ex. D-45; Tr. Vol. 4 at 981:11-18, 982:3-17, 991:24-992:2 (Felix).)

155. The MTC obtained information regarding TBI from Target's tax manager regarding TBI's business activities, how and when it was created, and how it obtained the IP that it was licensing. It is standard practice for the MTC to rely on the tax manager for information. The MTC requested that information so that it could make a judgment on how to proceed with the audit. (Tr. 980:24-982:17.)

156. The information that TBI provided to the MTC also included an acknowledgement that Target originally owned the IP that it transferred to TBI, and a document entitled “Business Purpose of Transfer” in which Target stated that it relied on the advice of its tax accountants in reaching and implementing its decision to create TBI as an intangible holding company. (Ex. D-45 at 1-2.)

157. The MTC auditor confirmed that TBI was an 80/20 company that should be excluded from the Target Corp. and Subsidiaries Colorado combined returns for tax years 2002-2004. (Ex. P-64 at 4.) This conclusion was based upon recognition of TBI’s own property and payroll factors and was made after consultation with representatives of the Department. (Tr. Vol. 4 at 1007:16-25 (Felix).)

158. The MTC’s auditors concluded, however, that TBI was subject to Colorado’s income tax on two bases: economic nexus and representational nexus. (Tr. 982:18-983:1.) The MTC auditor determined that TBI was “doing business in Colorado,” and was thus taxable in Colorado for tax years 2002-2004. (Ex. P-64 at 4; Tr. Vol. 4 at 982:18-983:1, 983:11-15 (Felix).) As Cathy Felix, the audit supervisor, testified, economic nexus means “a taxpayer is doing business by virtue of the economic presence in the state rather than a physical presence and it has a market within the state.” The MTC concluded that TBI had an economic presence in Colorado because “the license agreement provided that Target Corporation paid to -- as a licensing fee, . . . a percentage of its net sales so that every sale that Target Corporation made, a certain percentage of it is essentially then being paid as a royalty to Target Brands.” (Tr. 983:2-10, 984:16-20.)

159. Ms. Felix also explained that representational nexus is a term that is based on another company doing activities that represent that particular company within the state. The

MTC concluded that Target was representing TBI in the State of Colorado because Target was creating a market in the state for TBI, and TBI received royalties on every sale that was made by Target in Colorado. (Tr. 984:6-15.) The MTC also concluded that TBI was "doing business in Colorado" because "[i]t was conducting licensing activities within the state since it received license fees from Target Corporation, which were based on sales that Target Corporation made within the state." (Tr. 983:11-21.)

160. The MTC also concluded that Colorado had the authority to tax TBI for the years at issue in the MTC Audit because it was a nonfiler, meaning that it had not filed a return in Colorado. (Tr. 992:7-23; Ex. P-64 at 30.)

161. The MTC recommended Colorado issue assessments against TBI as a separate entity of $1,465,733 for 2002, $1,488,130 for 2003, and $2,025,388 for 2004. (Ex. P-64 at 11-13 (figures are tax only, before any interest or penalties).)

162. The MTC consulted with the Department regarding its conclusions about Colorado's ability to tax TBI because MTC auditors act as agents for the states, but the states issue the assessments. The states make the final determination with respect to how to handle the MTC's audit recommendations. (Tr. 984:21-985:11, 995:19-996:25.)

163. The MTC's auditor also consulted with the Department regarding the apportionment method. Following consultation with the Department, the MTC's auditor understood that the Department did not want to apply the standard UDITPA three-factor formula to apportion TBI's income to Colorado, but instead wanted the MTC to apply a single sales factor. (Ex. P-64 at 8; Tr. Vol. 4 at 991:10-23, 1008:1-13 (Felix).)

164. The MTC concluded that the standard apportionment formula did not accurately reflect TBI's activities within Colorado because TBI earned hundreds of millions of dollars in

royalties from sales in Colorado and TBI's royalty income was computed based on a percentage of the sales that Target made, but the standard formula would have led to zero income being apportioned to Colorado. (Tr. 985:12-987:13.) The MTC auditor recognized that, under the standard UDITPA three-factor formula, TBI would not have any income sourced to Colorado. (Tr. Vol. 4 at 991:7-9 (Felix).)

165. The MTC concluded that using a property factor was not appropriate in apportioning TBI's income to Colorado because the tangible personal property that TBI had was a very small number in comparison to the dollar amount of the sales that it made. Similarly, the MTC concluded that using a payroll factor was not appropriate when apportioning TBI's income to Colorado because the amount of its payroll was very small in comparison to its net income. (Tr. 987:14-25.)

166. Those property and payroll figures are reflected in Exhibit P-46, and those are the numbers that the MTC relied on in determining that using the standard apportionment formula would not fairly represent TBI's business activity in Colorado. (Tr. 988:4-990:24.)

167. In making the determination to exclude TBI's payroll and property factors, the MTC auditor did not analyze TBI's activities in Hong Kong or Minnesota. Ms. Felix testified that she believed TBI's "activities in Hong Kong wouldn't be relevant to determining the Colorado apportionment factor." (Tr. Vol. 4 at 1010:3-11 (Felix).)

168. On July 11, 2007, the Department issued its Assessment to TBI for tax years 2002-2004 based on the MTC audit. The Department applied interest and a delinquent payment penalty to the assessed taxes for each year. TBI timely protested these Assessments. (TMO at 8, ¶¶ 8-9; D-112.)

169. In its audit of Target Corp. and Subsidiaries, the MTC did not disallow or adjust Target's royalty expense deduction for the royalties paid to TBI. (Tr. Vol. 4 at 1010:13–1011:2 (Felix).)

170. Like the earlier 2003 audit, the MTC did not find that Target had engaged in any abuse for tax years 2002-2004. There is no evidence of abuse by Target in its formation of TBI or in its payment of a royalty to TBI, nor is there any evidence that the royalty rate was excessive or abusive. (Tr. Vol. 3 at 860:24-861:13 (Reilly); Tr. Vol. 4 at 1010:13-1011:8 (Felix).)

iii. <u>MTC Audits of TBI for other States</u>

171. In addition to Colorado, three other states involved in the joint audit of TBI (Arkansas, West Virginia, and New Mexico) made separate assessments against TBI. One other state (Kentucky) did not pursue TBI separately because it had a statute at the time that required potential taxpayers to have a physical presence in Kentucky to have nexus. (Tr. 1002:17-1003:12.)

172. Of the 4 states that participated in the MTC's audit of TBI, two states (Arkansas and West Virginia) directed the MTC to apply a three-factor apportionment formula, and two states (Colorado and New Mexico) directed the MTC to use a single sales factor. (Tr. Vol. 4 at 1014:21–1015:6 (Felix).)

173. It is clear from Ms. Felix's testimony that the approaches of the other states were based on their particular laws, regulations, and guidance. (Tr. Vol. 4 at 1002:22-1007:15, 1012:19-1013:1, 1014:21-1015:14 (Felix).) The Court therefore finds that an MTC audit performed for another state should not determine how, if at all, TBI should be taxed in Colorado.

iv. Department Audit of TBI for Tax Years 1999–2001 and 2005–2009

174. In early 2011, the Department's Chief Auditor, Sharon Stehr, made the decision to audit Target in 2012 (the "Bookend Audit"). (Tr. 669:10-24.) Misgana Tesfaye was assigned as the lead auditor on the Bookend Audit. (Tr. 655:4-13.) In August 2011, the Department notified Target it intended to audit Target Corporation and Subsidiaries in 2012. (Tr. 655:14-17, 674:18-675:22.) In 2012, Target had approximately 50 subsidiaries listed on its federal tax Form 1120, Schedule 851. (Tr. 687:8-20.)

175. At the time, Mr. Tesfaye was an audit group manager assigned to a group within the Department's Field Audit Section called Audit Selection and Tracking ("AST"). (Tr. Vol. 2 at 527:9-11, 530:21-25 (Tesfaye).)

176. Part of Mr. Tesfaye's job as manager of AST was to track the Field Audit Section's annual "Audit Production" figures and prepare reports which showed the Audit Production amounts on a monthly and yearly basis. (Ex. P-90; P-134; Tr. Vol. 2 at 530:1-531:12 (Tesfaye).)

177. Each year, including fiscal year 2012, the Field Audit Section of the Department had annual "Audit Production Goals" which included a goal for total dollars in tax adjustments, a goal for total hours spent auditing, and a goal for total audits performed. (Ex. P-115; Tr. Vol. 3 at 567:15-568:20 (Tesfaye).)

178. For fiscal year 2012, the Field Audit Section's annual Audit Production Goal for dollars in tax adjustments was $221,955,510.74. (Ex. P-115; Tr. Vol. 2 at 532:3-533:10 (Tesfaye).)

179. The Field Audit Section also kept track of an auditor's "hourly rate," which was the total amount of time spent on an audit divided by the tax dollars adjusted. (Ex. P-134; Tr. Vol. 3 at 570:1-5 (Tesfaye).)

180. The Court rejects TBI's assertion of an improper motive on the Department's part for the assessment of taxes.

a. Three Department representatives (John Vecchiarelli, Senior Director of Tax, and the two auditors on the Bookend Audit) testified that employees were not rewarded in any way based on the number of dollars assessed against taxpayers. (Tr. 1253:18-1254:4.)

b. The Department's Statement of Taxpayer Rights, which was given to taxpayers at the beginning of an audit, strictly prohibits the use of the amount of taxes assessed to evaluate employees or to impose production goals on individual employees. (Tr. 1254:5-1255:11.)

c. The primary evidence relied upon by TBI to show an improper motive was that the Department audited and assessed taxes against TBI shortly before the end of the Department's 2011-2012 fiscal year to meet production goals. However, the Department convincingly countered TBI's interpretation of that fact with the following evidence:

    i. The Bookend Audit was assigned in early 2011, more than a year before the audit started. (Tr. 655:8-13.)

    ii. The Department also scheduled the date of the onsite audit in 2011, well in advance of the 2011-2012 fiscal year, which ended on June 30, 2012. (Tr. 655:14-17.)

iii. The audit of Target Corporation and subsidiaries other than TBI did not conclude until the spring of 2013. (Tr. 657:25-658:3, 919:6-21.)

iv. The auditors broke with their normal practice and completed the TBI audit separately from the Target combined group audit and prior to the end of the 2011-2012 fiscal year at the request of a Target Tax Department employee, Jennifer Romans, who was due to be out of the office on maternity leave. (Tr. 657:8-659:1, 919:22-920:5.)

181. The auditors conducted part of the audit at Target's offices in Minneapolis for two weeks in April 2012. (Tr. 657:8-10.) In advance of this field work, the auditors reviewed Target's federal returns for tax years 2007 through 2010 and noticed a large discrepancy between the amount of Target's federal taxable income and its Colorado taxable income. (Tr. 688:21-690:18.) After arriving in Minnesota, the auditors discovered the discrepancy was due to TBI—Target had excluded TBI from its Colorado taxable income. (Tr. 688:21-690:18.)

182. The Department did not originally notify Target that TBI would be audited. While in Minnesota performing the audit of Target, Mr. Tesfaye and another auditor, Mr. Gorman, discovered that TBI had been previously audited by the MTC, and that such audit was under protest and pending before the Department's Tax Conferee. (Tr. Vol. 2 at 434:19-435:6 (Romans); Tr. Vol. 3 at 691:12-692:3 (Tesfaye).) When they learned of the MTC audit, they reviewed the MTC's audit papers and agreed with the MTC's analysis and conclusion that TBI, while an 80/20 company, had nexus to Colorado and was subject to Colorado corporate income tax. (Tr. 695:12-19, 693:15-696:18.)

183. While in Minnesota, Mr. Tesfaye and Mr. Gorman began to audit TBI for tax years 2007 through 2009. The Department's auditors then requested information relating to TBI

for tax years 2005 and 2006, and ultimately added tax years 1999, 2000, and 2001. (Tr. Vol. 2 at 415:6-418:2 (Romans).)

184. The auditors performed an independent review of TBI for the tax years 2005 through 2010 and confirmed the same analysis applied. TBI was an 80/20 company for tax years 2005-2009, but it ceased being an 80/20 company in 2010. (Tr. 693:15-694:10.)

185. The Bookend Audit adopted the rationale of the MTC audit:

a. TBI generated Colorado-sourced income because it earned a royalty on the sales at Target's Colorado stores and had an income tax nexus to Colorado. (Ex. P-78 at 4-6; Tr. 681:17-682:5.)

b. Including payroll and property in the apportionment analysis would not fairly reflect TBI's business activities in Colorado. (Ex. P-78 at 4-6; Tr. 681:17-682:5.)

186. TBI and Target were surprised when the Department indicated it planned to audit TBI for tax years 1999, 2000, and 2001. Target believed that tax years 1999-2001 were closed because of the prior audit of Target Corp. and Subsidiaries for those same years (the 2003 audit). (Tr. Vol. 2 at 418:3-19, 434:19-23 (Romans).)

187. Ms. Jennifer Romans expressed this belief in an email exchange with the Department's auditors.

188. The Department's Chief Auditor, Ms. Sharon Stehr, also expressed concern about whether the Department could audit TBI for tax years 1999-2001. In an email to Mr. Tesfaye, Ms. Stehr indicated that if the "[2003] audit had other entities file separate returns we will have a harder case to make that we didn't audit Brands." (Ex. P-79.)

189. After deciding to audit TBI for the Bookend Years, the Department's auditors contacted Mr. Cary Kelliher, the Tax Conferee assigned to TBI's protest of the MTC audit. In an

email exchange, Mr. Kelliher provided the Department's auditors with an excerpt from a letter he had written which contained analysis of some of the issues which were raised in TBI's protest of the MTC audit. (Exs. P-76; D-148, p. 5; Tr. Vol. 3 at 608:7-609:12, 694:18-695:11 (Tesfaye).)

190. During the Bookend Years audit, the Department's auditors determined that TBI was "an 80/20 company that should not be combined with the main consolidated group." (Exs. P-78; D-148; Tr. Vol. 2 at 436:16-437:11 (Romans); Tr. Vol. 3 at 605:7-606:10, 607:5-608:6 (Tesfaye).)

191. In making the determination regarding TBI's 80/20 status, the Department's auditors respected TBI's property and payroll factors. (Tr. Vol. 3 at 606:11-15 (Tesfaye).)

192. Rather than conducting a complete analysis of TBI's business activities, the Department's auditors relied primarily upon the correspondence from Mr. Kelliher, the Tax Conferee, and the MTC audit, which the Department's auditors attempted to follow. (Exs. P-148; D-148; Tr. Vol. 3 at 696:7-15 (Tesfaye).)

193. The Department's auditors did not interview any TBI employees nor visit any TBI offices during their audit, even though TBI had employees in Minnesota. Moreover, the Department's auditors stated that they were not even aware at the time of their audit that TBI had employees in Minnesota, even though it was evident from the apportionment work papers that TBI had payroll in Minnesota for each of the Years at Issue. (Exs. P-26, P-31, P-37, P-50, P-60, P-67, P-73, P-74, Tr. Vol. 3 at 624:17-625:1 (Tesfaye).)

194. Prior to issuing the Assessments relating to the Bookend Years, the Department's auditors were not aware of, nor did they consider TBI's various business activities, including its brand acquisition, brand management, brand protection, brand compliance, and sourcing activities. (Tr. Vol. 3 at 627:11-629:22 (Tesfaye).)

195. In the Bookend Years audit, the Department did not apply the UDITPA three-factor formula to apportion TBI's income to Colorado. (Exs. P-148 at 2, D-148; Tr. Vol. 3 at 651:23-652:2, 707:20-708:3 (Tesfaye).)

196. Rather than applying the UDITPA standard three-factor formula, the Department used an alternative apportionment method which relied solely upon the single sales factor of Target. (Exs. P-148 at 2, D-148; Tr. Vol. 3 at 651:23-652:5, 708:4-8, 713:18-714:7 (Tesfaye).)

197. The Bookend Audit resulted in assessments against TBI for the following tax amounts (interest and penalties not included): \$965,368 (1999); \$1,167,089 (2000); \$1,414,671 (2001); \$1,851,313 (2005); \$2,184,230 (2006); \$2,391,169 (2007); \$2,461,406 (2008); \$2,513,474 (2009). (Ex. D-112 at 2; Tr. 1296:5-13, 1298:6-15, 1300:4-1301:2.)

198. In the Assessments for the Bookend Years, the Department also applied interest and imposed negligence penalties, estimated payment penalties, and delinquent payment penalties. These Assessments were postmarked June 28, 2012, and TBI timely protested these Assessments on July 27, 2012. (TMO at 8, ¶¶ 10-11; Ex. D-112.) The Department imposed negligence penalties and estimated tax penalties for the Bookend Years, even though it had not done so for tax years 2002-2004. (*See* Ex. D-112.)

199. Approximately one month before the trial in this matter, the Department waived the negligence penalties that had been imposed in the Bookend Years audit. (Ex. D-112, p. 2; Tr. Vol. 5 at 1297:5-1298:5, 1310:4-10 (Kelliher); Gill 30(b)(6) testimony at 39:4-40:24.)

200. In addition to the audit of TBI for the Bookend Years, the Department also completed a separate audit of Target Corp. and Subsidiaries. In the audit of Target Corp. and Subsidiaries, the Department did not challenge the amount of Target's royalty payments to TBI, nor did the Department disallow Target's royalty expense deduction. Further, the Department

did not find that Target had engaged in any abuse. (Tr. Vol. 3 at 632:13-633:18, 726:13-17 (Tesfaye).)

201. Specifically, Mr. Tesfaye testified that the Department could not show that TBI's royalty income lacked economic substance, that the Department could not show that the royalty payments were invalid, and that he believed TBI's 80/20 status had to be respected. (Tr. Vol. 3 at 728:12-729:1 (Tesfaye).)

J. Delays by the Department

202. TBI timely protested the MTC audit Assessment on August 9, 2007 and requested a hearing before the Executive Director of the Department. (TMO at 8, ¶ 9.)

203. TBI's protest was not assigned to Mr. Cary Kelliher, the Tax Conferee, until July 7, 2008, nearly a year later. (Ex. D-60; Tr. Vol. 5 at 1312:14-1313:12 (Kelliher).)

204. The Department cannot explain the one-year delay in assigning the matter to the Tax Conferee. (Tr. Vol. 5 at 1313:18-23 (Kelliher].)

205. Once the case was assigned to him, Mr. Kelliher held an informal conference with representatives of TBI in September 2008. (Tr. Vol. 5 at 1315:4-24 (Kelliher).)

206. Mr. Kelliher held a second informal conference with representatives of TBI over two years later, in November 2010. (Tr. Vol. 2 at 411:5-15 (Romans); Tr. Vol. 5 at 1315:25-1316:5 (Kelliher).)

207. Mr. Kelliher testified that he could not recall what was being done on the TBI protest during the two years between informal conferences. Specifically, Mr. Kelliher could not recall conducting any factual investigations, legal research, or having any communications with TBI during those two years. (Tr. Vol. 5 at 1316:6-1317:20 (Kelliher).)

208. Following the second informal conference in November of 2010, the parties exchanged correspondence in an attempt to resolve the matter. (Tr. Vol. 2 at 411:19-412:2 (Romans); Tr. Vol. 5 at 1317:25-1319:18 (Kelliher).)

209. After attempts to resolve the matter had failed, in December of 2011, TBI reiterated its request for a hearing and asked Mr. Kelliher to forward its protest to the Hearings Section. Mr. Kelliher did not transmit TBI's protest for a hearing until August 2014. (Ex. P-97; Tr. Vol. 2 at 411:19-412:17, 443:20–444:24 (Romans); Tr. Vol. 5 at 1319:6-25 (Kelliher).)

210. On April 25, 2012, Mr. Kelliher was informed via email by Mr. Tesfaye that the Department was in the process of auditing TBI. In an email exchange with Mr. Tesfaye, Mr. Kelliher indicated that TBI's protest of the MTC audit was going to formal hearing and that he had all the information he needed to refer the matter for a hearing. (Ex. P-76 at 2; Tr. Vol. 5 at 1321:1-1322:4 (Kelliher).)

211. In the same email exchange, Mr. Kelliher indicated that he planned to transmit TBI's protest for a hearing in the fiscal year of July 2012-June 2013. (Ex. P-76.) At trial, Mr. Kelliher testified that he was not sure why he was planning to wait until fiscal year 2012-2013 to transmit the TBI matter for a hearing. (Tr. Vol. 5 at 1324:13-1326:5 (Kelliher).) Mr. Kelliher did not, in fact, transmit TBI's protest of the MTC Assessment to the hearings division in the 2012-2013 fiscal year.

212. While TBI's protest of the MTC audit was assigned to Mr. Kelliher, TBI received the Assessments based on the Bookend Years audit and protested those Assessments. TBI's protest of the Bookend Years audit was also assigned to Mr. Kelliher. (Tr. Vol. 2 at 441:22-442:4 (Romans).)

213. Mr. Kelliher conducted another informal conference with representatives of TBI in April 2013, after which TBI again reiterated its request that its protests be forwarded for a hearing. (Tr. Vol. 2 at 442:5-13, 443:7-12 (Romans).)

214. Mr. Kelliher did not transmit TBI protests for hearing until August of 2014, which was approximately seven years after TBI's protest of the MTC audit was filed, and two years after TBI's protest of the Bookend Years audit. (Ex. P-97; Tr. Vol. 2 at 443:20-444:24 (Romans); Tr. Vol. 5 at 1325:21-1326:5 (Kelliher).)

215. Mr. Kelliher testified that the Department's delays in this matter were "absolutely" not appropriate. Mr. Kelliher testified: "I think it's not appropriate for any appeal to take as long as this did, and I wish the circumstances would have been different. I wish that I would have been able to manage the load that I had more efficiently, but it is what it is." (Tr. Vol. 5 at 1329:24-1330:11 (Kelliher).) The Court agrees that the Department's delay in moving this case through the appeals process was not appropriate.

K. <u>TBI's Tax Filings in Other States</u>

216. Evidence was introduced at trial regarding TBI's payment of taxes in other states. The Court finds that this evidence is relevant only to the question of whether Colorado's taxation of TBI violates the Commerce Clause of the United States Constitution. The constitutional principles are the same in every state and the relevant facts of TBI's business (e.g., the location of its property, payroll, and sales and TBI's receipt of royalties based on Target's sales) are the same in each of the jurisdictions.

217. During the Years at Issue, TBI paid corporate income taxes in some states and did not pay corporate income tax in others. In each situation, TBI's tax filings depended upon the law in the particular jurisdiction. (Ex. D-115; Tr. Vol. 2 at 472:19-474:13 (Romans).)

218. TBI filed separate company returns and paid corporate income tax as follows:

a. TBI filed separate company returns and paid corporate income tax in South Carolina from the year of its inception through 2009. (TBI 30(b)(6) Dep. (Romans) 85:14-86:10.) TBI did not have any property, payroll, or sales in South Carolina. (Tr. 461:14-463:7.)

b. TBI paid corporate income taxes to New Jersey for the years 1999-2009. (TBI 30(b)(6) Dep. (Romans) 76:22-77:7, 77:15-78:9.)

c. TBI paid corporate income taxes to Oklahoma for the years 2003-2009. (TBI 30(b)(6) Dep. (Romans) 78:23-79:8, 80:16-81:3, 82:20-83:5.)

d. TBI paid corporate income tax in Arkansas for the years 2005-2009 following an audit. (TBI 30(b)(6) Dep. (Romans) 95:21-25.)

e. TBI paid corporate income tax in Florida for the years 2003-2009. (TBI 30(b)(6) Dep. (Romans) 96:4-10.)

f. TBI paid corporate income tax in Iowa for the years 2003-2009. (TBI 30(b)(6) Dep. (Romans) 96:23-97:2.)

g. TBI paid corporate income tax in New Mexico for the years 2006-2009. (TBI 30(b)(6) Dep. (Romans) 98:19-23.)

h. TBI paid corporate income tax in North Carolina for the years 2003-2009. (TBI 30(b)(6) Dep. (Romans) 101:23-102:6.)

i. TBI paid corporate income tax in West Virginia for the years 2005-2008. (TBI 30(b)(6) Dep. (Romans) 103:21-104:2.)

j. The only state in which TBI paid corporate income tax without having first been audited was South Carolina. (TBI 30(b)(6) Dep. (Romans) 104:18-106:8.)

219. Each state has its own corporate income tax regime; the regimes across the nation are varied not only with respect to the types of entities and income that are taxed, but also with respect to the manner in which such entities and income are taxed and specifically with respect to how income is apportioned. (Tr. Vol. 3 at 759:5-11 (Pomp); Tr. Vol. 4 at 998:20-1000:6 (Felix).)

220. Some states require full combined reporting, some allow or require combined reporting only in specified circumstances (such as Colorado), and some states require separate returns from each corporation which reports income in its state. (Tr. Vol. 3 at 741:15-745:21 (Pomp).)

221. In addition, some states have specific statutes or regulations requiring physical presence for purposes of their corporate income tax, while others have specific regulations regarding economic nexus. (Tr. Vol. 3 at 1003:6-24 (Felix).) Each state is free to determine who will be subject to its tax, and it would be permissible for a state to interpret its statutes to require a corporation to have a physical presence in the state in order to be subject to income taxation. (Tr. Vol. 4 at 1167:16-1168:21 (Miller).)

222. Each aspect of a state's corporate income tax regime reflects an array of legislative policy and value judgments, including considerations of economic development, administrability, and predictability, among others. Quite often, these judgments have tax consequences. (Tr. Vol. 3 at 741:15-743:16, 783:1-14 (Pomp).)

223. There is no impropriety in a taxpayer structuring itself or its business in a manner so as to benefit from a state's choices regarding how to apply and compute its corporate income tax. (Tr. Vol. 3 at 741:15-743:16, 783:1-14 (Pomp).)

224. Apportionment formulas vary from state to state. Some state statutes require or allow the use of UDITPA's three factor (payroll, property, and sales) formula, while others do

not. (Tr. Vol. 4 at 756:5-757:3, 759:5-21 (Pomp).) While the standard UDITPA formula gives equal weight to each of the three factors, some states have chosen by statute to give greater—or even exclusive—weight to certain of the factors. (Ex. D-126, p. 14.)

225. States also vary in the way they require application of the apportionment factors. With respect to the sales factor, the standard UDITPA apportionment formula sources income from services and intangible property according to where the greater proportion of the income producing activities takes place, based on costs of performance. § 24-60-1301 art. IV, § 17. However, either by statute or by regulation, some states have amended the sales factor to source income from services or intangibles based on where the service or intangible is received or utilized, *i.e.*, a market-based sourcing approach. (Tr. Vol. 4 at 1123:11-1124:12, 1194:23-1195:18 (Miller).) For example, evidence at trial demonstrated that as far back as 1985, the California Franchise Tax Board promulgated an industry-wide regulation, requiring licensors of IP to calculate their sales factor using a market-based methodology. (Ex. P-122; Tr. Vol. 4 at 1195:19-1196:18 (Miller).)

226. In 2014, the MTC modified its model sales factor regulation to incorporate market sourcing of receipts from intangibles. (Tr. Vol. 4 at 1180:20-1181:10, 1190:4-1194:5 (Miller).)

227. The Colorado General Assembly never modified the sales factor in the standard UDITPA formula to require market sourcing of receipts from intangible property. (Tr. Vol. 4 at 1193:23-1194:5 (Miller).)

228. The Department never promulgated a regulation to require market sourcing of receipts from intangible property under the UDITPA formula. (Tr. Vol. 4 at 1200:2-7 (Miller).)

L. Experts

229. Both sides presented expert testimony from well-respected state tax authorities. While the testimony was helpful to the Court from a historical perspective, most of the opinions intruded upon the Court's responsibility to determine the law.

M. Overview of Key Fact Findings

230. TBI was properly formed and operated for legitimate business purposes. (Tr. Vol. 4 at 1216:14-25 (Miller).)

231. TBI is not a sham entity, nor is there any evidence that TBI lacked economic substance or that TBI's receipt of royalties from Target was abusive. (Tr. Vol. 3 at 770:18-772:1, 782:20-25, 805:14-20 (Pomp); Tr. Vol. 4 at 1203:7-16 (Miller).)

232. TBI is a separate legal entity from its parent, Target Corporation. For taxation purposes, TBI is a separate taxpayer. (Tr. Vol. 3 at 604:18-605:6 (Tesfaye).)

233. Intellectual property holding companies have not been uncommon or unusual. (Tr. Vol. 4 at 1202:11-1203:16 (Miller).)

234. While tax considerations were part of the impetus for TBI's formation, there is no evidence of any abuse by Target in the formation of TBI or in the payment of royalties to TBI.

235. The Department has never challenged the royalty rate paid to TBI, nor was there any evidence presented to suggest that the royalty rate was improper. The royalty rate was established through arms-length transfer pricing reports and was proper. (Exs. P-2, P-15, P-33, D-59; Tr. Vol. 2 at 471:11-19 (Romans); Tr. Vol. 3 at 860:24-861:13 (Reilly).)

236. For each of the Years at Issue, TBI was an 80/20 company. TBI's formation as a separate company and its structure as an 80/20 company must be respected. At the same time, TBI's status as both an IHC and 80/20 company is unusual.

237. TBI did not have a physical presence in Colorado during any of the Years at Issue. It is undisputed that, during the Years at Issue, TBI had neither employees nor tangible property in Colorado. (Ex. P-64 at 22; Tr. Vol. 3 at 617:22-24, 636:16-18, 637:19-23 (Tesfaye); Gill 30(b)(6) testimony 62:10-13, 72:20-23, 72:25-73:6, 73:8.)

238. While the MTC and the Department conducted audits of TBI and reviewed certain information related to TBI's activities, the Court finds that neither the MTC nor the Department adequately considered the full extent of TBI's business activities.

239. It is undisputed that if the standard UDITPA three-factor formula were applied to TBI, none of TBI's income would be apportioned to Colorado. (Gill 30(b)(6) testimony 71:20-22.) This is because during the Years at Issue, TBI had no tangible property in Colorado, TBI had no employees in Colorado, and TBI had no sales in Colorado as measured by the greater proportion-of-costs-of-performance approach. (Tr. Vol. 4 at 1128:6-1129:3 (Miller).)

240. Nonetheless, TBI received substantial income based on Target's sales in Colorado.

CONCLUSIONS OF LAW

A. Legal Issues Before the Court

1. The parties presented several legal issues for resolution at trial. Two of those issues affect all of the Years at Issue: (1) whether Colorado has the statutory and constitutional authority to tax TBI, and (2) assuming Colorado may tax TBI, what formula should be used to apportion TBI's income to Colorado.

2. TBI raises additional challenges with more limited application. TBI has argued that the statute of limitations and the doctrine of equitable estoppel prohibit the Department from issuing assessments related to tax years 1999 through 2001. TBI has also argued that good cause

exists to waive the interest and penalties assessed against it. The Court addresses each of these issues below, concluding with a discussion of the appropriate remedy in this matter.

3. First, a C corporation is only required to file a Colorado income tax return and pay any income tax to Colorado if it is "doing business" in the state. C.R.S. § 39-22-301(1)(d)(I). TBI contends that it was not doing business in Colorado during the Years at Issue. If the Court agrees, then the Assessments must be cancelled.

4. Second, if the Court determines that TBI was "doing business" in Colorado, it must determine how to apportion TBI's income to Colorado. There is no dispute that UDITPA's standard three-factor apportionment formula would apportion none of TBI's income to Colorado, and therefore, TBI would owe no income tax to Colorado. However, Section 18 of UDITPA permits departure from the standard formula when those provisions "do not fairly represent the extent of the taxpayer's business activity in this State . . . ." § 24-60-1301, art. IV, § 18 ("Section 18"). If the Court concludes the Department has not satisfied the statutory and regulatory standards to invoke Section 18, then the Assessments must be cancelled.

5. Third, if the Court determines that the Department met its burden to depart from the standard apportionment formula, it must determine whether the Department satisfied a second legal burden—to demonstrate that its alternative apportionment formula was reasonable and equitable under the circumstances. In the Assessments, the Department eliminated all three of TBI's factors under the standard apportionment formula (TBI's payroll, property, and sales factors) and replaced those factors with a single sales factor. TBI has challenged this alternative formula on grounds that, in <u>solely</u> employing a sales factor to apportion TBI's income, the Department unreasonably and inequitably omitted a broad range of business activities performed by and with TBI's employees (payroll) and tangible assets (property) to produce the subject

income. TBI therefore contends that if alternative apportionment is allowed, the alternative formula, at a minimum, must include TBI's payroll and property factors. If the Court finds that the Department has not sufficiently validated its alternative methodology, it may order modification of the formula. § 39-21-105(2)(b) ("The district court may affirm, modify, or reverse the determination of the executive director and may enter judgment on its findings.").

6. Fourth, TBI contends the Assessments, as issued, violate the Commerce Clause of the U.S. Constitution. In particular, TBI contends the Assessments violate 3 of 4 established elements of Commerce Clause analysis: substantial nexus, fair apportionment (specifically, the external consistency requirement), and fair relationship between the tax imposed and the services provided by the taxing state.

7. Fifth, if the Court determines that TBI owes any income tax to Colorado, it must determine whether the Department was barred from assessing tax for the first three of the Years at Issue, tax years 1999-2001. TBI contends that any assessment of tax for these three years is barred under the statute of limitations by virtue of the Department's 2003 audit, and that such Assessment is also barred under principles of equitable estoppel.

8. Sixth, if the Court determines that TBI owes any income tax to Colorado, it must determine whether some or all of the interest and penalties assessed should be abated. TBI contends that interest and penalties should be abated for a number of reasons, including: (a) incorrect or misleading guidance issued by the Department regarding the subject legal issues, (b) the Department's multi-year delays in issuing the Assessments and in completing administrative proceedings on TBI's protests, which resulted in the accumulation of millions of dollars in additional interest, and (c) inappropriate conduct by the Department's auditors. The Court may order the Department to abate all or some of the interest and penalties assessed under

its general authority to modify the Assessments pursuant to § 39-21-105(2)(b), "for good cause" pursuant to § 39-21-112(8) (interest and penalty) and § 39-22-621(2)(j) (penalty), or under common law principles of equity.

B. <u>Standards of Review</u>

i. <u>The Court's Review of the Assessments Is Conducted De Novo</u>

9. The Court conducts its review of this matter *de novo* on all questions of law and fact. § 39-21-105(2)(b). Accordingly, this Court reviews the Assessments "as though no previous action had been taken." *M & J Leasing Co. v. Exec. Dir. of Dep't of Revenue*, 796 P.2d 28, 30 (Colo. App. 1990) (citation omitted).

ii. <u>Construction of Taxing Statutes and Regulations</u>

10. This matter requires the interpretation of multiple taxing statutes, including statutes concerning the State's jurisdiction to tax and statutes governing the apportionment of income. It is settled that "taxing powers and taxing acts will not be extended beyond the clear import of the language used, nor will their operation be enlarged by analogy. All doubts will be construed against the government and in favor of the taxpayer." *Associated Dry Goods Corp. v. City of Arvada*, 593 P.2d 1375, 1378 (Colo. 1979) (internal citations omitted); *see also Bd. of Cnty. Comm'rs v. ExxonMobil Oil Corp.*, 192 P.3d 582, 586 (Colo. App. 2008). "Strict application of tax measures has been called a fundamental precept that protects citizens by informing them in unambiguous terms about the amount and nature of their duty to pay taxes." *Expedia, Inc. v. City & Cnty. of Denver*, No. 13CA0779, 2014 WL 2980979, at *5 (Colo. App. July 3, 2014) (internal quotations omitted), *cert. granted*, 2015 WL 5215961 (Sept. 8, 2015); *Washington Cnty. Bd. of Equalization v. Petron Dev. Co.*, 109 P.3d 146, 150 (Colo. 2005) (taxpayer is entitled to "legitimate favorable construction" of a tax statute).

11. With respect to Colorado's income tax statutes, these common law principles are extended by legislative directive:

> It is the intent of the general assembly that, in interpreting or construing the provisions of this part 3 [corporate income tax], statutes shall be given the strongest weight, then rules and regulations, and then the administrative interpretation or construction of said provisions by the executive director or the department of revenue; the administrative interpretation shall be given no greater weight than the interpretation of the taxpayer regardless of how long-standing such administrative interpretation or construction might be, unless such administrative interpretation or construction is set forth in rules and regulations promulgated by the executive director.

§ 39-22-310. The Department's interpretation of the corporate income tax statutes is not entitled to deference unless taxpayers are notified of that interpretation by formal regulation.

Where the Department has expressed its interpretation by regulation, additional rules of construction apply. "An agency must scrupulously follow the regulations and procedures it promulgates and, if it does not, the court may strike the agency's action." *Rags Over the Ark. River, Inc. v. Parks & Wildlife Bd.*, 360 P.3d 186, 191 (Colo. App. 2015). Requiring an agency to follow its own regulations both "ensures reliability and fairness" and "comports with principles of due process; that is, the public is entitled to know the manner in which an agency will render a decision and the factors the agency will consider." *Id.*; *see also Charnes v. Robinson*, 772 P.2d 62, 66 (Colo. 1989) (in dealing with an agency, the public is entitled to know the "rules of the game").

C. <u>Colorado has the Authority to Tax TBI's Income</u>

12. TBI bears the burden of demonstrating that Colorado lacks the authority to tax TBI's income. § 39-21-105(2)(b). TBI has asserted two arguments to support its assertion that Colorado cannot tax its income.

13. First, TBI claims that Colorado's corporate income tax is inapplicable to it because TBI is not "doing business in Colorado." (Compl. ¶ 70, 89(a)); *see also* § 39-22-301(1)(d)(I). Second, TBI claims that even if Colorado has the statutory authority to tax TBI's income, Colorado's assertion of taxing authority over TBI violates the Commerce Clause of the United States Constitution. (Compl. ¶¶ 77-82, 89(f)); *see also* U.S. CONST. art. I, § 8, cl. 3.

i. <u>"Doing Business" under Colorado's Income Tax Laws</u>

14. As threshold matter, the Court must determine whether Colorado law required TBI to file income tax returns and pay any calculated income tax to the state. Colorado imposes an annual income tax upon any C corporation "doing business" in this state: "A tax is imposed upon each . . . foreign C corporation doing business in Colorado annually in an amount of the net income of such C corporation during the year derived from sources within Colorado . . . ." § 39-22-301(1)(d)(I).[3]

15. At the outset, the Court concludes that the statutory "doing business" analysis may be distinct from a constitutional analysis of jurisdiction to tax under the Due Process and Commerce Clauses of the U.S. Constitution. The Court agrees with a leading treatise in the field of state taxation, which instructs: "Wholly apart from constitutional limitations on state jurisdiction to tax . . . , questions arise as to whether the taxpayer's activities fall within the statutory definition of 'doing business' within a state." WALTER HELLERSTEIN, JEROME HELLERSTEIN, & JOHN SWAIN, STATE TAXATION ¶ 6.16 (3d ed. 2016) ("Hellerstein").

16. In applying the "doing business" requirement to this case, the Court notes first that the phrase "doing business in Colorado" was not defined in Colorado's taxation statutes.

[3] This foundational provision in the corporate income tax statutes identifies both *who* is subject to the tax ("a corporation doing business in Colorado"), and *what* is subject to tax (income "derived from sources within Colorado"). An ensuing subpart of the statute amplifies the latter issue, stating that "income from sources within Colorado shall be determined in accordance with the provisions of this part 3," *i.e.*, principally, the apportionment provisions that direct how income from sources within Colorado should be calculated. § 39-22-301(1)(d)(II).

§ 39-22-301(1)(d)(I). During the Years at Issue, a Department regulation defined "Doing business in Colorado," in full, as follows:

> A corporation will be considered to be doing business in Colorado whenever the minimum standards of Public Law 86-272 are exceeded. Public Law 86-272 protects manufacturers whose only business activity conducted in a state is soliciting orders for sale of tangible personal property. Sales of services are not protected by Public Law 86-272. A "safe harbor" lease transaction, by itself, does not create nexus for Colorado income tax purposes.

(Ex. P-128 (Department Reg. 39-22-301.1).) The referenced Public Law 86-272, a federal law codified at 15 U.S.C. §§ 381-384, established a safe harbor from state income taxation for certain activities associated with the sale of <u>tangible</u> personal property within a state. Through the regulation, the Department acknowledged and embraced the federal mandate. However, the regulation was silent with respect to activities involving <u>intangible property</u>, including the licensing of intangible property.

17. The Department provided additional guidance regarding its interpretation of the "doing business" standard in an "FYI – For Your Information" publication. FYI Income 58 explained the Department's interpretation of the "doing business" standard exclusively within the context of the state's corporate income tax. The narrative stated, in part:

> Corporations that do not have employees nor stocks of goods in Colorado and do not engage in activities in the state, other than the shipping of goods to customers in Colorado pursuant to orders received by mail, telephone or the internet, are not doing business in Colorado and are not subject to Colorado income tax.

(Exs. P-45; P-63 (01/05 & 03/07 versions of FYI Income 58).) For a number of the Years at Issue, the Department followed the quoted text with a footnote to *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), indicating that the types of activities that would be considered "doing business" in Colorado are those held sufficient to establish a state's taxing jurisdiction under

Quill.[4] In *Quill*, the U.S. Supreme Court affirmed, in the context of a use tax dispute, that a taxpayer must have a "physical presence" (*e.g.*, employees or tangible property) in a taxing jurisdiction in order for that jurisdiction to impose its tax. *Quill*, 504 U.S. at 312-18.

18. The FYI publication does not bind the Department, and could not be fairly interpreted as applying to intangible property.

19. The Court finds that Colorado's "doing business" requirement, at least with respect to licensors of intangible property, has not been defined by regulation. In the absence of a regulation supporting its interpretation of the "doing business" requirement, as applied to companies such as TBI, the Department's interpretation is not entitled to any deference. § 39-22-310.

20. The Department contends that *Coors Porcelain Co. v. State,* 517 P.2d 838 (Colo. 1973) ("*Coors*"), supports its position. While the *Coors* Court stated that "we are inclined to agree with the statement of the Attorney General that our General Assembly has sought to tax all the *income* that Colorado can constitutionally tax," *id.* at 840 (emphasis added), the Court was not asked to evaluate the threshold question of whether the taxpayer was "doing business" in Colorado. Coors Porcelain ("Coors") had an office in Golden, Colorado; it unquestionably was "doing business" in the state. *Id.* The primary question being examined was not whether Coors was taxable in Colorado, but rather whether Colorado could tax all of Coors's *income*, including income derived from sales into other states where it was not "doing business." *Id.* at 840-41. *Coors* does not address the question presented by this case.

21. Even if "doing business in Colorado" is not co-extensive with the constitutional tests, nor specifically defined by regulation for intangible property, the Court concludes that TBI

[4] It was not until a March 2008 printing of FYI Income 58 that the Department removed the footnote to *Quill*—after the vast majority of the Years at Issue had passed. P-068.

was doing business in Colorado. TBI chose to license its IP for use by Target in Colorado. TBI chose to base the royalties it would receive under that license on Target's sales both in Colorado and nationwide. TBI relied on Target to present TBI's IP—its central asset—in the best possible light in Colorado, and, to some extent, directed those efforts. Finally, TBI received hundreds of millions of dollars in income related to the use of its IP in Colorado. The Court concludes that even if "doing business in Colorado" is not necessarily co-extensive with the constitutional tests, TBI was doing business in Colorado.

ii. ***<u>Colorado's Taxation of TBI Does Not Violate the Commerce Clause</u>***

22. The only constitutional issue before the Court is whether the Commerce Clause of the United States Constitution prohibits Colorado from taxing TBI. (*See* Compl. ¶¶ 77-83, 89(f) (citing U.S. CONST. art. I, § 8, cl. 3).)[5] The Commerce Clause—particularly the dormant Commerce Clause—prevents states from discriminating against or unduly burdening interstate commerce. *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 287 (1997). At the same time, nothing in the Commerce Clause prevents a state from requiring interstate commerce to "pay its way." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 281 (1977) (internal quotation marks omitted).

23. A four-part test governs the Commerce Clause analysis. If a tax "is [1] applied to an activity with substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the state," the tax does not violate the commerce clause. *Id.* at 279; *see also Amerada Hess Corp. v. Dir., Div. of Taxation, N.J. Dep't of the Treasury*, 490 U.S. 66, 72-79 (1989); *AT&T Commc'ns v. Dep't of Revenue*, 778 P.2d 677, 681 (Colo. 1989) (citing *Complete Auto*, 430 U.S. at 278).

[5] TBI has not raised any constitutional claims other than the Commerce Clause claim described below, thereby waiving any other constitutional challenges. *See generally* Complaint; *see also* § 39-22-105(2)(b).

24. TBI challenges the Department's Assessments under three of those tests: the substantial nexus, fair apportionment, and fairly related elements. The Assessments must satisfy all of these disputed tests to be sustained.

iii. <u>TBI Has Substantial Nexus with Colorado</u>

25. The United States Supreme Court has never defined "substantial nexus" other than to hold that it means something more than the minimum-contacts nexus necessary to comport with due process. *Quill*, 504 U.S. at 312-13. Beyond that, substantial nexus is a fact-based test, applied on a case-by-case basis and intended to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Id.* at 313-14 (discussing concerns behind the substantial nexus test and recognizing that "Commerce Clause jurisprudence now favors more flexible balancing analyses . . . .").

26. The Court acknowledges a split in legal authority concerning whether an entity's licensing of IP to an affiliate establishes a substantial nexus between the licensor and the states in which the licensee utilizes the IP in conducting its retail sales operations. The debate centers in large part on whether the "physical presence" requirement established by the U.S. Supreme Court in *Quill*, a use tax case, applies only to sales and use taxes, or also to income and franchise taxes. Certain state courts have held that the licensing of IP to an affiliate creates an "economic presence" of the licensor in the jurisdictions where the licensee operates that is sufficient to support imposition of an income/franchise tax. These cases generally follow the analysis of *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993). Other state courts have reached a contrary conclusion, holding that *Quill*'s physical presence requirement indeed applies to income and franchise taxes, and that "economic presence" does not suffice. *See, e.g.*, *J.C. Penney Nat'l Bank* v. *Johnson*, 19 S.W.3d 831, 840-42 (Tenn. Ct. App. 1999) (applying

physical presence requirement to reject claim that credit card company had established a substantial nexus with Tennessee by virtue of solicitation activities and presence of the cards themselves (deemed to be intangible assets) within the state); *Galland Henning Nopak, Inc. v. Combs*, 317 S.W.3d 841, 844-45 (Tex. App. 2010) (applying "bright-line" physical presence test of *Quill* to determine substantial nexus for purposes of Texas' franchise tax). *See also* Hellerstein, *supra*, ¶ 6.11[3].

1. <u>Physical Presence is not Required to Establish Substantial Nexus</u>[6]

27. The confusion regarding the physical-presence issue stems from the application of two U.S. Supreme Court cases that arose in the sales and use tax context: *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and *Quill*. Prior to those cases, it was clear that the Commerce Clause did not require a physical presence in the taxing state for income tax purposes. *See, e.g.*, *Int'l Harvester Co. v. Wis. Dep't of Taxation*, 322 U.S. 435, 441-42 (1944) ("A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers."). However, following *Bellas Hess*'s adoption of a physical-presence rule in the sales and use tax context—and its subsequent affirmation in *Quill*—courts have confronted whether the physical-presence rule from *Bellas Hess* applies to all types of tax or whether its application is limited to the sales and use tax context from which the rule arose.

[6] The Court heard testimony about four TBI enforcement actions involving Colorado parties, none of which resulted in litigation or reached the Colorado courts. At most, these events are relevant to a Due Process Clause "minimum contacts" analysis. They are not relevant to a "substantial nexus" analysis under the Commerce Clause. *See Quill*, 504 U.S. at 313 ("Thus, the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, contrary to the State's suggestion, a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause.").

See, e.g., *Lanco, Inc. v. Dir., Div. of Taxation*, 879 A.2d 1234, 1236-40 (N.J. Super. Ct. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006) (per curiam), *cert. denied*, 551 U.S. 1131 (2007).

28. *Bellas Hess* involved Illinois's attempt to require an out-of-state mail-order retailer to collect and remit use taxes to Illinois. The extent of National Bellas Hess's contact with Illinois was its twice-yearly mailing of a catalog through the postal service or common carrier, occasional additional fliers, and sending purchased goods to customers in Illinois through the postal service or common carrier. *Bellas Hess*, 386 U.S. at 754-55. It had no property, employees, or representatives in Illinois. *Id.* at 754.

29. The *Bellas Hess* Court rejected Illinois's attempt to impose its use tax on National Bellas Hess, noting that it "ha[d] never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail." *Id.* at 758. The Court expressed concern that if Illinois could require National Bellas Hess to collect and remit use taxes on these facts, then "so [could] every other State, and so, indeed [could] every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes." *Id.* at 759.

30. At the time, there were approximately 2,300 jurisdictions authorized to impose sales and use taxes. *Id.* at 759 n.12. The Court recognized that "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National [Bellas Hess's] interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'" *Id.* (footnotes omitted). Thus, the Court held that, in the context of use

taxes being imposed on a mail-order retailer, physical presence was required under the Commerce Clause for the tax to be valid. *Id.* at 758.

31. *Quill* followed approximately 25 years later, presenting a similar factual scenario: "a State's attempt to require an out-of-state mail-order house that has neither outlets nor sales representatives in the State to collect and pay a use tax on goods purchased for use within the State." 504 U.S. at 301. There, the Court concluded that its reasoning in cases following *Bellas Hess* did not "compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.* at 317.

32. This quote and *Quill*'s broader discussion of the physical-presence rule, however, answer the question before this Court: the physical-presence rule is limited to sales and use taxes.[7] In *Quill*, the Court noted that it had never required that a taxpayer be physically present in a taxing state for any type of tax other than sales and use taxes. *Id.* at 314. This was true even for cases arising after *Bellas Hess*. *Id.* at 317. In those later cases involving other types of tax, the Court noted, it had adopted "more flexible balancing analyses" and the Court acknowledged that its more modern approach to the Commerce Clause "might not dictate the same result [as in *Bellas Hess*] were the issue to arise for the first time today . . . ." *Id.* at 310.

33. This Court also finds persuasive the reasoning from *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004). There, the North Carolina Court of Appeals explained why the physical-presence rule from *Bellas Hess* and *Quill* was specific to the facts and concerns in those cases. *Id.* at 193-96. As the *A&F Trademark c*ourt noted, one of the facts that convinced the Supreme Court to keep the physical-presence rule in place was that the mail-

[7] This is not to say that *Quill* has no application outside of sales and use tax. *Quill* sets forth the analytical distinctions between Commerce Clause and Due Process jurisprudence and provides guidance regarding both issues that has broader application. The question here, however, is whether *Quill*'s endorsement of the physical-presence rule from *Bellas Hess* applies to state income taxes. The Court concludes that it does not.

order retail industry had placed substantial reliance on the physical-presence rule, and the *Quill* Court was concerned with undermining those reliance interests. *Id.* at 194. The *A&F Trademark* Court reasoned that no similar reliance interest could arise in the context of other taxes because the physical-presence rule had never applied to other types of taxes. *Id.* Thus, the reliance interests *Quill* sought to protect are not implicated in refusing to expand the physical-presence rule to other types of tax.

34. Additionally, there are material differences between sales and use taxes and income taxes that support a different standard. *Id.* at 194-95; *see also* Jerome R. Hellerstein, Geoffrey *and the Physical Presence Nexus Requirement of Quill*, 8 State Tax Notes 671, 676 (1995). For example, a sales or use tax requires a retailer to serve as the state's collections agent, imposing a greater burden than an income tax. Additionally, "a state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." 605 S.E.2d at 195 (quoting *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *rev'd on other grounds*, 131 P.3d 22 (N.M. 2005)) (internal quotation marks omitted). At the time of *Bellas Hess* there were over 2,300 potential sales and use tax jurisdictions. *Bellas Hess*, 386 U.S. at 759 n.12. By the time of *Quill*, that number had grown to over 6,000 jurisdictions. *Quill*, 504 U.S. at 313 n.6. There is no evidence before this Court establishing that similar burdens exist in the income tax context.

35. For all of these reasons, the Court concludes that physical presence is not required to create a substantial nexus for state income tax purposes.[8] The United States Supreme Court

[8] The Court also notes that the majority of jurisdictions that have addressed the physical-presence question in the income tax context have held that physical presence is not required to impose an income tax. *See* Hellerstein, *supra*, ¶ 6.11(2)-(4); *see also* James A. Amdur, Annotation, *State Income Tax Treatment of Intangible Holding Companies*,

has never required physical presence in the context of state income tax; the physical-presence rule from *Bellas Hess* and *Quill* is specific to the sales and use tax arena; and that rule does not supersede the Supreme Court's earlier holdings.

2. <u>Substantial Nexus: Licensing Intellectual Property for use in Colorado and Tying Royalty Payments to Target In-state Sales</u>

36. The Court concludes that TBI has a substantial nexus with Colorado. The substantial nexus test is primarily focused on ensuring that the states do not unduly burden interstate commerce through the imposition of taxes. *See Quill*, 504 U.S. at 313. Under the facts of this case, it would not unduly burden interstate commerce to hold that TBI is subject to Colorado's income tax.

37. TBI licensed its IP to Target for use nationwide, including in Colorado. At that time, Target had stores in Colorado, which TBI knew when it entered into the License Agreement with Target. TBI chose to tie its payments under the License Agreements to Target's in-store sales; therefore, TBI knew it would be relying on the activities in each state where Target operated for its revenue and made a conscious decision to exploit the markets in each state to produce its income. And as a result of this arrangement, TBI received substantial income from Colorado.

38. No undue burden on interstate commerce results from requiring TBI to pay Colorado income tax under these facts. As numerous other states have concluded when confronted with IHCs, these facts are sufficient to subject TBI to Colorado's income tax. *See Geoffrey, Inc. v. Comm'r of Revenue*, 899 N.E.2d 87, 92-93 (Mass. 2009), *cert. denied*, 557 U.S. 920 (2009); *Lanco*, 879 A.2d at 1235-42; *Kmart*, 131 P.3d at 31-40; *A&F Trademark*, 605 S.E.2d at 195; *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632, 635-41 (Okla. Civ. App.

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11 A.L.R. 6th 543, § 2 ("[C]ourts generally have held that the physical presence requirement does not apply to income taxes . . . .").

2005); *Geoffrey, Inc. v. S.C.*, 437 S.E.2d at 18-19; *see also KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308, 310-11, 328 (Iowa 2010) (regarding an out-of-state franchisor), *cert. denied*, 132 S. Ct. 97 (2011).

iv. The Tax Assessed against TBI is Fairly Apportioned.

39. The second contested prong of the *Complete Auto* test asks whether the subject tax is "fairly apportioned."[9] *Complete Auto*, 430 U.S. at 279. The fair apportionment prong requires that the tax be both internally consistent and externally consistent. *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184-85 (1995). TBI contends the single-factor apportionment formula applied in the Assessments is not externally consistent.

40. The Constitution does not require a specific apportionment formula. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978) (recognizing that "the States have wide latitude in the selection of apportionment formulas"). The relationship between the tax and the interstate activity being taxed need not be perfect. *Amerada Hess*, 490 U.S. at 74.

41. To succeed in its challenge, TBI must demonstrate that "the income attributed to [Colorado] . . . has 'led to a grossly distorted result.'" *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983) (quoting *Moorman Mfg.*, 437 U.S. at 274).

42. The external consistency test requires that "the factor or factors used in the apportionment formula . . . actually reflect a reasonable sense of how income is generated." *Id.* at 169. Phrased differently, "[t]he external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed." *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989), *abrogated in part on other grounds as recognized in Comptroller v. Wynne*, 135 S. Ct. 1787, 1798 (2015).

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[9] The Court distinguishes apportionment as a constitutional issue from the statutory matter addressed *infra*. To the extent they overlap, the constitutional issue is resolved by the Court's conclusions regarding statutory apportionment.

43. The Department's approach reflects a reasonable sense of how TBI's income is generated, making it externally consistent. TBI's agreement with Target provides that, in exchange for the use of TBI's IP, Target will pay TBI a percentage of every sale at a Target store, including those in Colorado. Moreover, the evidence before the Court demonstrates that TBI's income is primarily generated through Target's sales. By apportioning TBI's income with reference to Target's sales, the Department's apportionment method reasonably reflects how TBI earns its income and is externally consistent.

44. TBI has also argued that in providing brand-related and product-sourcing services, TBI is helping to increase Target's sales, which leads to greater royalty income for TBI. Thus, TBI claims, not including payroll or property fails the external consistency test despite the terms of the License Agreement.

45. The Court concludes that TBI has not met its burden given the evidence in the record. The Court cannot determine the value TBI added to Target's performance that would allow it to conclude that "the income attributed to [Colorado] . . . has 'led to a grossly distorted result.'" *Container Corp.*, 463 U.S. at 170 (quoting *Moorman Mfg.*, 437 U.S. at 274). The evidence TBI has presented is insufficient to overcome the plain terms of the License Agreement (on which the Department modeled its apportionment method) and the understanding of its first President, Ms. Street, regarding the basis for the royalty payments: the royalty payments are made solely for the right to use TBI's IP. Therefore, the Court concludes the second part of the Commerce Clause test is satisfied.

v. The Tax Assessed Against TBI is Fairly Related to Benefits Provided by the State of Colorado

46. The fourth part of the Commerce Clause test requires that the tax be fairly related to benefits conferred by Colorado. *Complete Auto*, 430 U.S. at 279. "The purpose of this test is

to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State." *Goldberg*, 488 U.S. at 266-67; *see also Quill*, 504 U.S. at 313 (1992) (holding the test's purpose is to ensure the tax "does not unduly burden interstate commerce"). It does not require an analysis of the costs the state has incurred because of the taxed activity or the value of the state services compared to the amount of the tax. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 627-28 (1981). "[I]nterstate commerce may be required to contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct benefit." *Goldberg*, 488 U.S. at 267 (quoting *Commonwealth Edison*, 453 U.S. at 627 n.16) (internal quotation marks omitted).

47. The Court finds that there is a fair relationship between the taxes assessed against TBI and the benefits Colorado provides. The undisputed evidence is that without the benefits Colorado provides, Target would have no inventory to sell at its stores, no employees to make those sales, and no customers to buy Target's products—all of which would mean that TBI would receive no royalty income from Colorado.

48. To the extent Colorado provides additional services to Target that allow Target to operate its stores here, those services similarly benefit TBI. Those other services include police, fire department, and 911 services, all of which Target's store policies indicate an intent to use. Therefore, the Court concludes that TBI benefits from the services Colorado provides and that the tax is fairly related to these benefits because these services make the generation of TBI's royalty income possible.

vi. <u>Conclusions Regarding Colorado's Constitutional Taxing Authority</u>

49. In sum, the Court concludes that Colorado's taxation of TBI does not violate the Commerce Clause: (1) TBI has substantial nexus with Colorado; (2) the tax is fairly apportioned;

(3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to benefits provided by the State of Colorado. Colorado's income tax may be constitutionally applied to TBI.

D. <u>The Department's Apportionment of TBI's Income</u>

50. Apportionment refers to the division of a corporation's tax base by formula. Formulary apportionment balances the administrative ease of using a formula (as opposed to direct allocation) with reaching a fair and reasonably accurate distribution of a corporation's tax base. *See Gen. Motors Corp. v. D.C.*, 380 U.S. 553, 561 (1965) (formulary apportionment "can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates."); Hellerstein, *supra*, ¶¶ 9.01, 9.02.

i. The Relevant Statutes, Regulations, and Legal Standards

51. For tax years 1999 through 2008, one of Colorado's standard formulas was the three-factor formula.[10] *See* § 24-60-1301, art. IV. This formula comes from a model law, the Uniform Division of Income for Tax Purposes Act ("UDITPA"),[11] that has been adopted by numerous states. The standard UDITPA three-factor formula apportions income to Colorado by (1) determining the percentage of a taxpayer's property,[12] payroll, and sales in Colorado; (2) adding those percentages together; and (3) dividing the combined percentage by three to create an apportionment factor. *Id.* art. IV, § 9. The taxpayer's net income is then multiplied by the apportionment factor, which results in Colorado taxable income. § 39-22-301(1)(d)(I) ("A tax

[10] Colorado also had a two-factor formula during this period, and taxpayers could elect to use either formula. TBI has represented that it would have used the three-factor formula had it filed an income tax return in Colorado. *See* Compl. ¶ 40. Thus, the two-factor formula is not relevant here.

[11] Although the Uniform Division of Income for Tax Purposes Act ("UDITPA") was approved as a uniform law in 1957, it was not adopted in Colorado (as the Multistate Tax Compact) until 1968. § 24-60-1301, art. IV.

[12] As used in the standard apportionment formula, "property" includes only real and tangible property. § 24-60-1301, art. IV, § 10. It does not include intangible property.

is imposed . . . in an amount of the net income . . . derived from sources within Colorado . . . .”). Colorado taxable income is multiplied by the applicable tax rate, leading to the tax due. *Id.* These calculations are presented below:

$$CO_{\text{Apportionment Factor}} = \left[\frac{CO_{\text{prop}}}{\text{Total}_{\text{prop}}} + \frac{CO_{\text{payroll}}}{\text{Total}_{\text{payroll}}} + \frac{CO_{\text{sales}}}{\text{Total}_{\text{sales}}} \right] \div 3$$

$$CO_{\text{Apportionment Factor}} \text{ x Net Income} = CO_{\text{Taxable Income}}$$

$$CO_{\text{Taxable Income}} \text{ x } CO_{\text{Tax Rate}} = \text{Colorado Income Tax Due}$$

52. Beginning with tax year 2009, the General Assembly replaced the standard formulas with a single-sales factor method. § 39-22-303.5(2)(b), (4)(a). In single-sales factor apportionment, the apportionment factor is equal to the percentage of the taxpayer’s sales sourced to Colorado. The remaining calculations are the same. Colorado’s adoption of single-sales factor apportionment was part of a movement among the states towards emphasizing sales in apportioning income; the U.S. Supreme Court has held that using a single-sales factor method is presumptively valid. *See Moorman Mfg.*, 437 U.S. at 273.

53. When determining where a sale occurs for the purpose of standard three-factor apportionment, sales other than those of tangible personal property are sourced to Colorado under the existing Section 17 of UDITPA only if: “(a) the income-producing activity is performed in this State; or (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.” § 24-60-1301, art. IV, § 17.

54. However, the General Assembly—in both its adoption of UDITPA and, later, single-sales factor apportionment—gave the Department discretion to use an alternative method

of apportionment when the standard formulas "do not fairly represent the extent of the taxpayer's business activity" in Colorado. § 24-60-1301, art. IV, § 18; *see also* § 39-22-303.5(7)(b).

55. The Colorado regulation regarding the implementation of Section 18 adds the requirement that it may only be invoked in cases where "unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results" under the standard apportionment formula. 1 CCR 201-3, Reg. IV.18(a) (2009).

56. The party seeking to use alternative apportionment (here, the Department) is responsible for demonstrating (1) that the default apportionment formulas do not fairly reflect TBI's business activity in Colorado, and (2) that the Department's proposed alternative method is reasonable. *See Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169, 1178 (Cal. 2006) (applying two-part burden); *Twentieth Century-Fox Film Corp. v. Dep't of Revenue*, 700 P.2d 1035, 1038 (Or. 1985).[13] The burden of proof is preponderance of the evidence. § 13-25-127.

ii. ***Application of UDITPA's Standard Apportionment Formula***

57. The Court next must determine whether the Department was required to apply UDITPA's standard three-factor formula in apportioning TBI's income to Colorado, or whether the Department permissibly departed from the standard formula under Section 18. This analysis necessarily begins with a review of each of the three standard factors and their application to the facts of this case.

58. UDITPA's standard formula sourced taxpayers' income through evenly weighted payroll, property, and sales factors. These factors are intended as proxies for the business activities of a corporation. Each factor divides the amount of the identified proxy located in the

[13] *See also Union Pac. Corp. v. Idaho State Tax Comm'n*, 83 P.3d 116, 120 (Idaho 2004) ("The party asserting alternative apportionment . . . bears the burden of showing that the alternative apportionment is appropriate."); *Bellsouth Adver. & Publ'g Corp. v. Chumley*, 308 S.W.3d 350, 362 (Tenn. 2009) ("The burden is on the party seeking a variance to establish that the formula does not fairly represent [the taxpayer's] business activities in the taxing state.").

subject state (numerator) by the amount of the proxy located everywhere (denominator) to obtain a fraction. The three factors (fractions) are then summed and divided by three. The resulting average of the three factors is then multiplied by the taxpayer's total taxable income to obtain a portion that is sourced to (and, after potential further adjustments, taxed by) the subject state—here, Colorado.

59. There is no dispute that each of TBI's payroll, property, and sales factors—if computed according to the UDITPA statute and supporting Department regulations—would have sourced none of TBI's income to Colorado; therefore, TBI would have owed no tax to Colorado. The UDITPA payroll factor considers the amount paid "by the taxpayer for compensation," and the Department's regulation elaborates that "[o]nly amounts paid directly to employees are included in the payroll factor." § 24-60-1301, art. IV, § 13; 1 CCR 201-3, Reg. IV.13.(a)(4). None of the compensation that TBI paid annually to employees was assigned to Colorado because all of TBI's employees were located outside Colorado. TBI's Colorado payroll factor was zero.

60. The UDITPA property factor considers "the taxpayer's real and tangible personal property owned or rented . . . ." § 24-60-1301, art. IV, § 10. None of TBI's real and tangible personal property was in Colorado because all of its offices and operations were outside the State. TBI's Colorado property factor was zero.

61. The Court heard substantial testimony concerning UDITPA's sales factor. UDITPA prescribes a specific methodology for sourcing sales "other than sales of tangible personal property," including income from intangible property and services. This methodology sources gross receipts from such transactions to Colorado only if "a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of

performance." *See* § 24-60-1301, art. IV, § 17(b); 1 CCR 201-3, Reg. IV.17. The Department's regulation defined "income producing activity" as activity "directly engaged in by the taxpayer" and excluded "transactions and activities performed on behalf of a taxpayer." 1 CCR 201-3, Reg. IV.17(2). This "greater proportion" analysis, by design, does not apportion receipts from intangible property or services to the location where the property/services are utilized or received. That is, it is not a market-based sourcing approach. Rather, this methodology sources the entirety of such receipts to the single state where the taxpayer incurred the greater proportion of the costs to perform its income producing activities, an origin-based approach.[14] All of TBI's income producing activities, and therefore all of its costs to perform those activities, were performed outside Colorado. TBI's Colorado sales factor was zero.

62. Because all three of TBI's Colorado factors were zero under the standard apportionment formula, none of TBI's income would have been sourced to Colorado for taxation. Again, this result is not disputed. The issue before this Court is whether the Department is permitted by Section 18 to substitute an alternative apportionment methodology to calculate TBI's Colorado taxable income. The Court now turns to those questions.

iii. The Department's Proposed Application of Section 18

1. **Section 18: Its Terms and Required Inquiries**

63. Section 18 authorizes departure from the standard apportionment formula under certain circumstances. The section provides:

> If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> a. separate accounting;

[14] UDITPA and the Colorado Legislature chose a different rule for sales of tangible personal property, sourcing such revenues to the state to which the property is "delivered or shipped," *i.e.*, to the state of the market for such tangible goods. § 24-60-1301, art. IV, § 16(a).

b. the exclusion of any one or more of the factors;
c. the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
d. the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

§ 24-60-1301, art. IV, § 18.

64. A Department regulation in effect during all of the Years at Issue described a narrow scope of authority for any party seeking to invoke alternative apportionment:

> [Section 18] permits a departure from the allocation and apportionment provisions of Article IV <u>only in limited and specific cases</u>. [Section 18] may be invoked only in specific cases where <u>unusual fact situations</u> (<u>which ordinarily will be unique and nonrecurring</u>) <u>produce incongruous results</u> under the apportionment and allocation provisions contained in Article IV.

1 CCR 201-3, Reg. IV.18(a)(2) (2009) (emphasis added). The Colorado Supreme Court, as well, has endorsed a narrow application of alternative apportionment. Addressing a similar statute authorizing alternative apportionment under Colorado's former two-factor formula, the Court instructed: "That section is to be narrowly construed and employed only in unusual situations." *Miller Int'l, Inc. v. Dep't of Revenue*, 646 P.2d 341, 345 (Colo. 1982). This Court will likewise interpret the Department's authority under Section 18 narrowly and will strictly apply the terms of the Department's own regulation. *Rags over the Ark. River*, 360 P.3d at 191 ("An agency must scrupulously follow the regulations and procedures it promulgates and, if it does not, the court may strike the agency's action.").

65. It is widely accepted, including by the parties to this action, that substituting an alternative apportionment formula for UDITPA's standard formula requires two separate showings, and that the party seeking alternative apportionment—here, the Department—bears the burden of proof on each. First, as a predicate to invoking Section 18 at all, it must be shown, under the plain language of Section 18, that the "apportionment provisions of this Article [*i.e.*, the standard formula] do not fairly represent the extent of the taxpayer's business activity in this

State." Second, it must be shown that the proposed alternative formula chosen is "reasonable." *See, e.g.*, *Microsoft Corp.*, 139 P.3d at 1178; *Twentieth Century*, 700 P.2d at 1042-43. The Court will apply a preponderance of the evidence standard to both burdens. § 13-25-127(1).

2. **The Department Justified Application of Section 18**

66. This is an unusual fact situation in which use of the standard three-factor formula does not fairly represent the extent of TBI's business activity in Colorado. While an increasing number of intangible holding companies have been used by taxpayers around the country, it was not until the late 1990s and early 2000s that litigation over them resulted in significant numbers of published opinions. *See* Xuan-Thao N. Nguyen, *Holding Intellectual Property*, 39 Ga. L. Rev. 1155, 1157 (2005) (the IP holding company tax avoidance scheme "has been widely and quietly utilized in the last twenty years . . . ."). As Conferee Cary Kelliher testified, this is the first IHC case that the Department has taken to administrative hearing and that has been appealed to district court. (Tr. 1308:10-19.) While he is aware of other IHC cases that have been protested, even those were only in the last four or five years. (Tr. 1309:2-7, 1336:5-6.) Most significantly, TBI has not pointed to, nor is the Court aware of, any other case in any jurisdiction in which the IHC in question was also an 80/20 company, such that a company would avoid paying any income tax in the relevant state.

67. The Court concludes that the Department has met its burden of establishing that the use of the standard formulas in this case would not fairly represent the extent of TBI's business activity in Colorado. Application of the standard three-factor apportionment formula for the periods through 2008, or the standard single sales factor for 2009, would result in TBI owing no income tax to the State of Colorado. Despite receiving hundreds of millions of dollars based on royalties from sales in Colorado, it is undisputed that TBI has no property, payroll, or

sales here, as those terms are defined in the statutes in effect during the Years at Issue. With respect to the sales factor, the Court concludes that TBI's income-producing activities—as determined in accordance with the standard cost-of-performance rule in Section 17 of UDITPA—occurred only in Minneapolis, Hong Kong, and Italy during the Years at Issue, meaning none of its sales would be sourced to Colorado under the standard formula.

68. The Department showed that the standard apportionment formulas do not fairly reflect TBI's business activity in Colorado because they do not account for the manner in which TBI's income is generated and where the income-generating activity occurs.

69. TBI argues that other states have taken express steps to modify their apportionment rules for licensors of intangible assets where they did not desire the result obtained under the standard UDITPA formula. A number of states have done so by statute, in particular, by modifying their sales factors to source income from intangibles under a market-based approach, rather than the origin-based, cost-of-performance approach. Other states have promulgated specific, industry-wide regulations for licensors. For example, as far back as 1985, California adopted a regulation that broadly instructed licensors to use a market-based sales factor. The MTC, as well, modified its model sales factor regulation in 2014 to incorporate market sourcing of receipts from intangibles. The Department has adopted industry-wide regulations for other industries, such as broadcasters, that embrace market sourcing. 1 CCR 201-3 (2009), Special Regulation for Television and Radio Broadcasting (found at page 32 of 53). However, the Department never promulgated a comparable regulation for IP licensors.

70. The Court is disinclined to permit the Department to accomplish indirectly what neither it nor the General Assembly could have done, but did not do, directly and expressly. *Expedia*, 2014 WL 2980979, at *5 ("Strict application of tax measures has been called a

fundamental precept that protects citizens by informing them in unambiguous terms about the amount and nature of their duty to pay taxes.") (internal quotation omitted); *Associated Dry Goods*, 593 P.2d at 1378 ("All doubts will be construed against the government and in favor of the taxpayer."). Nevertheless, for the reasons previously expressed, the Court concludes that it was not inappropriate for the Department to invoke Section 18 here. Section 18, in essence, is a safety valve to address unusual circumstances. Its purpose would be negated if it could not be applied when the Department arguably was slow to recognize that the possibility of such circumstances existed.

iv. __The Department's Proposed Alternative Apportionment Formula is Not "Reasonable"__

71. The next legal burden the Department must satisfy is to validate the alternative apportionment formula it constructed and applied in the Assessments. The Department eliminated all three of TBI's factors (payroll, property, and sales) under the standard UDITPA formula and substituted a single new factor to apportion TBI's income: the sales factor of TBI's parent, Target.

72. By the plain terms of Section 18, the Department must show that the alternative it selected is "reasonable"; and, because the Department has specifically invoked Section 18(d), it must show that the alternative produces an "equitable" allocation and apportionment of TBI's income. § 24-60-1301, art. IV, § 18; *Microsoft*, 139 P.3d at 1178; *Twentieth Century*, 700 P.2d at 1042-43. The Colorado Supreme Court has emphasized that "an inquiry into what is reasonable necessarily requires an examination of the underlying circumstances." *Ritzert v. Bd. of Educ. of Acad. Sch. Dist. No. 20*, 361 P.3d 966, 975-77 (Colo. 2015) (reviewing varied applications of the term "reasonable"). Accordingly, this Court finds that applying the reasonableness requirement

to the Department's methodology requires consideration of all material circumstances in this case.

73. The record in this case is replete with evidence of the material contributions made by TBI's employees and property toward creating, enhancing, and preserving the income the Department seeks to tax. These business activities included registering thousands of IP assets in the United States and abroad, monitoring for improper uses of TBI's IP, taking appropriate enforcement actions, providing IP-related training across the Target organization, and auditing vendors for compliance with brand standards. The Department's own expert, Mr. Miller, acknowledged that when he first reviewed the facts of this case, he had "concerns" about excluding TBI's payroll from the apportionment formula due to TBI employees' contributions to creating and maintaining the value of the IP portfolio. He further recognized the contribution of TBI's real and tangible assets, and he noted that, upon hearing the testimony of TBI's witnesses at trial, he had learned yet additional facts about activities performed by TBI.

74. The Court concludes that including TBI's payroll and property in any alternative apportionment formula is necessary. Further, the Court cannot accept the Department's approach as reasonable when it gave no consideration to TBI's efforts and activities. In light of the totality of circumstances presented at trial, particularly demonstrating the significant contributions made by TBI's payroll and property outside Colorado to the values the Department seeks to tax, omitting these factors is neither "reasonable" nor "equitable."

75. The Court's conclusion flows from TBI's contribution to Target's Colorado sales; for this reason, the Court rejects the Department's suggestion that Target's payroll and property are appropriate alternative factors.

76. The Court therefore orders that the Department include TBI's payroll and property factors in its apportionment formula.

E. <u>The Department May Not Assess TBI for Tax Years 1999-2001</u>

77. The Court next addresses TBI's argument that tax years 1999-2001 may not be assessed because (1) the statute of limitations has run on those years, and (2) the Department is equitably estopped from assessing those years. On August 18, 2016, the Department moved for partial summary judgment on both of these issues, arguing that as a matter of law neither the statute of limitations nor equitable estoppel applied. This Court granted partial summary judgment as to the statute of limitations only, holding that because TBI had not filed stand-alone tax returns for 1999-2001, the statute had not started to run. Having heard the evidence at trial and reconsidering the legal arguments put forth by the parties, the Court reconsiders its grant of partial summary judgment. *Forbes v. Goldenhersh*, 899 P.2d 246, 249 (Colo. App. 1994) ("[A] trial court remains free to reconsider an earlier partial summary judgment ruling absent the entry of judgment under C.R.C.P. 54(b)."). For the reasons set forth below, the Court holds that the Department is foreclosed from assessing any tax, penalties, or interest on TBI for the years 1999-2001.

i. ***<u>As a Result of the Department's Prior Audit of TBI, the Statute of Limitations on Tax Years 1999-2001 Has Run</u>***

78. Under Colorado's tax code, the presumptive statute of limitations for "the assessment of any tax, penalties, and interest" is "one year after the expiration of the time provided for assessing a deficiency in federal income tax . . . ." § 39-21-107(2). Since the standard limitations period for assessing a deficiency in federal income tax is three years, the presumptive limitations period for Colorado income tax purposes is four years. *See Markus v. Brohl*, No. 13CA1656, 2014 WL 5369981, at *3 (Colo. App. Oct. 23, 2014). This presumptive

limitations period is subject to certain exceptions. § 39-21-107(2). Among them, "if the taxpayer has been audited by the department for the year in question and the issues raised in the audit have been settled by agreement for payment or payment of deficiencies arising therefrom," any further assessment is limited to issues arising from adjustments to federal income tax by the IRS. *Id.*

79. It is undisputed that TBI did not file stand-alone income tax returns for any of the Years at Issue, including 1999-2001. However, as set forth in the findings of fact above, TBI was audited by the Department in 2003 as part of the Department's audit of Target Corp. and Subsidiaries. Stated somewhat simplistically, an audit of "Target and its subsidiaries" is an audit of Target and TBI. TBI's existence had been disclosed in Target's tax returns and its business activity had been accurately described as "[b]rand name promotion and protection." With full knowledge of TBI's income, payroll, and property, the Department determined that TBI was not doing business in Colorado and therefore owed no Colorado income tax for 1999-2001. The Department's auditor testified that "there was no indication that . . . [TBI] needed to file a Colorado return." In contrast, the Department did assess two other Target subsidiaries that were also excluded from Target's combined return, because the auditors found that those subsidiaries were doing business in Colorado. The Department also issued an assessment to Target following its audit. Those three assessments were paid without protest.

80. The issue presented is whether the Department's 2003 audit of TBI's tax years 1999-2001 (conducted as part of its audit of Target Corp. and Subsidiaries) closes the statute of limitations for those years, where the Department issued assessments to Target and other excluded subsidiaries that were paid without protest. Under the facts presented here, the Court holds that it does. Section 39-21-107(2) controls.

81. The Department argues that § 39-21-107(4) should apply and that it allows the Department to assess and collect tax from TBI at any time because TBI did not separately file a Colorado income tax return. The Court rejects this argument. First, to the extent that the two statutory provisions are inconsistent, § 39-21-107(2) controls because it specifically addresses the legal significance of an audit. *See Showpiece Homes Corp. v. Assurance Co. of Am.*, 38 P.3d 47, 53 (Colo. 2001). Second, TBI was indisputably a company disclosed in Target's 1999-2001 combined group tax return and the Court has found TBI was in fact the subject of the audit for these years in 2003. The Court finds it incongruous that a corporation acting in good faith could disclose its existence and nature of its business, be audited by the Department, have the Department determine there is no tax liability to the state, and yet remain subject to taxation forever under § 39-21-107(4). The Court does not believe such a scenario to have been the intent of the legislature in enacting § 39-21-107(4).

82. The result might be different in a case where there is no evidence that the non-filing taxpayer was itself examined as part of an audit of the corporate parent and subsidiaries. However, the evidence here establishes that TBI was the subject of the audit. Therefore, under § 39-21-107(2), the Department's limitations period to impose an assessment on TBI expired with the completion of its 2003 audit and the satisfaction of all identified deficiencies for Target and its subsidiaries. The disputed 1999-2001 assessments of TBI were not issued until June 28, 2012—almost nine years later. Accordingly, the assessments of TBI for tax years 1999, 2000, and 2001 must be cancelled in full.

83. "[A] statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy." *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. 296, 301 (1946). Taxpayers are entitled to finality with respect to their tax obligation—a

fundamental tenet of fairness that would be severely undermined if the statute of limitations never closed even after a taxpayer is audited and a determination made by the Department that the taxpayer's non-filing status was appropriate. Such a result would leave a taxpayer like TBI indefinitely subject to taxation for years that were already audited, even where (as here) the taxpayer's non-filing status was approved by the Department. This is untenable, and runs afoul of the policies underlying the statute of limitations. *Cf. Shell W. E&P, Inc. v. Dolores Cnty. Bd. of Comm'rs*, 948 P.2d 1002, 1007 (Colo. 1997) ("When a rigid application of the statute of limitations leads to an unjust result, courts may properly fashion an equitable exception to the limitations period that may be asserted against a governmental agency as well as against private persons.").

84. In light of the foregoing, the Court need not address equitable estoppel.

F. <u>Abatement of Penalties and Interest</u>

85. The Court next addresses TBI's contention that, should any tax against it be affirmed, penalties and interest should be abated. The Department only assessed delinquent payment penalties against TBI following the MTC audit (tax years 2002-2004). In the Bookend Years audit, the Department assessed delinquent payment penalties, but also added estimated payment penalties and negligence penalties. The Director upheld the assessment of all penalties and interest imposed against TBI in the Assessments. Approximately one month prior to trial, the Department waived the negligence penalties imposed for the Bookend Years, thus those penalties are no longer in issue here.

86. This Court, upon review of the matter *de novo*, has authority to "affirm, modify, or reverse the determination of the executive director and may enter judgment on its findings." § 39-21-105(2)(b). This authority applies not only to the tax figures, but to interest and penalties

as well. Further, under § 39-21-112(8), penalties and interest may be waived for "good cause shown." Thus, this Court has the legal authority to abate all or some of the penalties and interest.

i. Good Cause does not Exist to Waive All Penalties and Interest

87. The Court concludes that a waiver of all penalties and interest is inappropriate. First, although the Department had a process in place for providing taxpayers with formal guidance around the time of TBI's formation, there is no evidence that either TBI or Target sought guidance from the Department. (Tr. 1257:24-1259:16.)

88. Second, not only did TBI not seek formal guidance, but TBI has not demonstrated that it relied on any documents published by the Department. Thus, this case does not present a scenario where the Department has provided incorrect information to a taxpayer and the taxpayer has relied on that information to its detriment.

89. Third, even after the MTC Audit ended in 2007 and concluded that TBI was subject to Colorado's income tax, TBI continued not to file and pay Colorado income tax. While the Court understands that TBI disputed whether any tax was due, TBI's willful decision not to file and pay Colorado income tax even after being informed that Colorado considered TBI subject to Colorado's corporate income tax significantly undermines any possible good cause for TBI's failure to pay taxes due for tax years 2007 through 2009, which followed the MTC Audit. It also indicates to the Court that no matter when Colorado had discovered and assessed taxes against TBI, TBI would have refused to pay those taxes.

90. Fourth, and specific to the penalties, the two remaining penalties assessed are the delinquent payment penalty and the estimated tax penalty.[15] (*See* Ex. D-112 at 2.) Neither penalty requires a specific *mens rea*; rather, they are automatic regardless of a taxpayer's intent. §§ 39-22-606(3), 39-22-621(2)(b). Thus, whether TBI intentionally or negligently failed to pay

[15] The Department also assessed a negligence penalty but chose not to pursue that penalty at trial.

its taxes is irrelevant. Moreover, the amount due under those penalties stops increasing after a set period of time, meaning that the delays TBI has cited to the Court as justifying a waiver are irrelevant. §§ 39-22-606(3)(b)&(c), 39-22-621(2)(b). The penalties had already reached their maximums not long after the taxes were due, and no additional penalty amounts accrued after that time.

ii. Portions of the Interest Should Be Abated

91. If the Court determines that full abatement of all penalties and interest is not warranted, the Court may order partial abatement. The Department's inappropriate delays in handling TBI's protests justify waiver of at least a portion of the interest. The Court finds good cause exists to waive interest on the assessments arising out of the MTC Audit because of the delay between TBI's protest and proceeding before the Hearings Division of the Department of Revenue.

CONCLUSION

92. The Court orders that the parties confer regarding the proper recalculation of the Assessments in accordance with this Order. The parties shall report back to the Court in 21 days, following which time the Court will enter final judgment.