STATE OF MICHIGAN
DEPARTMENT OF LICENSING & REGULATORY AFFAIRS
MICHIGAN ADMINISTRATIVE HEARING SYSTEM - MICHIGAN TAX TRIBUNAL

Martha Stewart Living Omnimedia, Inc.,
Petitioner,

v

MTT Docket No. 409820

Michigan Department of Treasury,
Respondent.

Tribunal Judge Presiding
Cynthia J. Knoll

ORDER GRANTING PETITIONER'S MOTION FOR SUMMARY DISPOSITION

FINAL OPINION AND JUDGMENT

I. INTRODUCTION

Petitioner, Martha Stewart Living Omnimedia, Inc., conducted business through its wholly owned subsidiary, MSO IP Holdings, Inc. ("MSO") with Kmart Corporation ("Kmart") by licensing use of various trademarks, the Stewart Property and designs, and other intellectual property to Kmart. Petitioner filed Single Business Tax ("SBT") returns for the 2002, 2003, 2004, 2005, and 2007 tax years. Respondent audited Petitioner for those tax periods and issued Final Assessments alleging SBT liability. The assessments were based on Respondent's determination that the royalty income received by MSO and transferred to Petitioner was "miscellaneous income" to Petitioner, not royalty income; and therefore, could not be deducted as a royalty subtraction on Petitioner's SBT returns. Respondent issued Final Assessment Number R498801 for the 2002 through 2005 tax years. The assessment alleged SBT liability of $87,794.00, with interest in the amount of $36,373.16, for a total liability of $124,167.16. Respondent issued Final Assessment Number R764734 for the 2007 tax year in the amount of $7,321.00, with interest in the amount of $975.02, for a total of $8,296.02.

II. BACKGROUND

Petitioner and Kmart began a contractual relationship pursuant to a License Agreement dated January 28, 1997, granting Kmart a limited exclusive right relating to certain products. As consideration for the rights granted by Petitioner, Kmart agreed to pay a royalty calculated as a percentage of the cost of licensed products covered by the Agreement. Over the next several years, Petitioner entered into additional similar Agreements with Kmart (hereinafter referred to as Prior Agreements.) On November 30, 2000, Petitioner formed MSO, which issued 1,000 shares of stock to Petitioner in exchange for Petitioner's contribution of certain trademarks and retailer license agreements, including the Prior Agreements. A License Agreement was executed between MSO and Kmart, consolidating the Prior Agreements into a single agreement. On or about June 13, 2002, MSO assigned its trademarks back to Petitioner; however, it retained the License Agreement with Kmart. For the years at issue, Kmart remitted all royalty payments to

MSO, and MSO transferred such payments to Petitioner. Petitioner recorded the transferred revenues as royalty income and deducted such from its tax base on its SBT returns. It is Respondent's disallowance of these deductions that resulted in the subject assessments.

Petitioner requested an informal conference with Respondent's Hearing Division in this matter, which was held on May 18, 2010. The Hearing Referee found that Respondent properly disallowed the royalty subtraction and included the cash receipts from MSO in Petitioner's SBT tax base. On August 19, 2010, Respondent issued a Decision and Order, in which it adopted the Hearing Referee's recommendation and upheld the assessments against Petitioner. Final Assessments were issued on August 27, 2010. Petitioner timely filed this petition with the Tribunal appealing the Final Assessments.

On July 13, 2011, Petitioner filed a Motion for Summary Disposition under MCR 2.116(C)(10), requesting the Tribunal to cancel and set aside the Final Assessments at issue. On July 29, 2011, Respondent filed a response and Brief in Opposition to Petitioner's Motion for Summary Disposition and requested that the Tribunal grant Summary Disposition in its favor. On August 8, 2011, Petitioner filed a response to Respondent's Brief in Opposition to Petitioner's Motion for Summary Disposition.

For the reasons set forth herein, the Tribunal finds that the payments were royalty receipts and granting Petitioner's Motion for Summary Disposition is appropriate.

III. PETITIONER'S CONTENTIONS

Petitioner contends that by Respondent classifying its revenues from MSO as "miscellaneous revenue," Respondent ". . . ignores the ownership of the trademarks used by Kmart creating the royalties, recharacterizes revenue to a term undefined in the SBT Act without any legal authority or support, ignores the substance of the transaction, ignores the statutory language set forth in MCL 208.9(7)(c) and the rules of statutory construction, and is in error." Petitioner's Brief in Support of Motion for Summary Disposition, p. 7. Petitioner states that because it ". . . owned and controlled all of the Stewart Property, including the trademarks, MSO must have had legal authority to license the Stewart Property to perform under the License Agreement." *Id.* Petitioner cites *Mobil Oil v Department of Treasury*, 422 Mich 473; 373 NW2d 730 (1985), to support its stance that the payments made from MSO to Petitioner constituted compensation paid to an owner of a right or property for the use of such right or property.

Petitioner argues that:

> The revenue received by [Petitioner] Martha Stewart prior to the License Agreement, and MSO thereafter from Kmart, are royalties, as they are a percentage payment based upon sale of licensed products making use of the Stewart Property under the review, control and approval of the licensor. [Petitioner] Martha Stewart properly recorded these payments in its cash account general ledger and as royalty income.

Id. at 8. Petitioner relies on *Newark Morning Ledger Co v Department of Treasury*, unpublished opinion per curiam, decided December 8, 2009 (Docket No. 283723), lv den, 486 Mich 903 (2010), "Where there is a continuing interest in the product or service being sold, it is understood that a payment for each copy sold or for a share in the profit of natural resources is appropriate." Petitioner argues that recharacterization of a payment as something other than a royalty applies to situations where there is not a continuing right to payment. *Id.* at 7.

Petitioner also cites *Detroit Lions, Inc v Department of Treasury*, 157 Mich App 207; 403 NW2d 812 (1987), and states that it ". . . strongly supports the propriety of [Petitioner] Martha Stewart's reporting of royalties." *Id.* at 8. Petitioner states:

> In *Detroit Lions*, royalties were directly paid to the National Football League for the broadcast of football games. As a franchised team, the Detroit Lions were entitled to, and received, a portion of these transferred royalties. The Court of Appeals stated that since the contracts granted the networks "a license to use and exploit, under certain terms and conditions, **the product assembled by the NFL**, we believe the transaction cannot be characterized as a 'sale.' Rather, we believe the payments received by the plaintiff in connection with **the arrangement between the NFL and the networks** should be classified as 'royalties' as that term is used in MCL 208.9(7)." *Detroit Lions* at 218-219.

(Emphasis in original). *Id.* at 9. Petitioner argues that the facts of its case are similar to *Detroit Lions* in that royalties received by the NFL were considered royalty revenue and properly subtracted from the Detroit Lions SBT tax base. Petitioner's ". . . treatment of the Transferred Royalties should be consistently respected. . . ." *Id.*

Petitioner further contends that Respondent has not produced any authority supporting its position that MSO can be the only recipient of royalty revenues. Petitioner argues that because it owned the trademarks at issue, only it could grant authority and permission to make use of its intellectual property. "Payments made from MSO to . . . [Petitioner] constitute compensation paid to an owner of a right or property for the use of such right or property." *Id.* at 7, citing *Mobil Oil, supra.*

Petitioner states that if you look to:

> [T]he nature of the transaction . . . Martha Stewart owned and controlled the trademarks and other intellectual property for which Kmart paid a royalty. Kmart remitted payment to MSO, a wholly owned subsidiary of Martha Stewart which, at best, briefly held title to only three of the trademarks subject to the License Agreement. Martha Stewart must have granted MSO permission to use the trademarks and intellectual property in order for MSO to contractually fill its duties, responsibilities and obligations under the License Agreement.

Id. at 12. As such, "Respondent's attempts to limit the analysis to the four corners of the License Agreement must fail as the License Agreement contains language which necessarily requires an evaluation of facts and information that extend beyond the Agreement." *Id.* at 13.

Finally, Petitioner contends that Respondent cannot recharacterize Petitioner's royalty revenue as "miscellaneous revenue." Petitioner notes that the rules of statutory construction provide that if a statute is clear and unambiguous on its face, the courts must obey and enforce the statute as written. Petitioner states "MCL 208.9(7)(c) directs the deduction of all royalties to the extent included in arriving at federal taxable income, except for specifically enumerated royalties that are inapplicable to the licensing of the Stewart Property." *Id.* at 15. Petitioner argues that the SBT Act does not define miscellaneous revenue and does not expressly authorize recharacterization of the Transferred Royalties. Respecting the plain language of MCL 208.9(7)(c), in that all royalties may be deducted from a taxpayer's SBT tax base to the extent included in arriving at federal taxable income, shows that Petitioner's revenue was not miscellaneous and was properly treated as royalty income.

IV. RESPONDENT'S CONTENTIONS

Respondent contends that "[a]lthough MSO assigned the trademarks to [Petitioner] in 2002, there is no evidence to suggest that any other rights or obligations under the License Agreement were assigned by MSO." Respondent's Brief in Opposition to Petitioner's Motion for Summary Disposition, p 6. Respondent argues that pursuant to the License Agreement and amendment, MSO licensed the property rights to Kmart and received the royalty payments involved. It asserts that the License Agreement with Kmart provides that MSO retained all right, title, and interest in the Licensed Property. Citing paragraph IX of the License Agreement:

> The License Agreement confirms that MSO is the sole owner of the Licensed Property:
>
> (2) Kmart confirms the sole ownership by MSO of the Licensed Property and agrees that all use by Kmart of the Licensed Property shall inure solely to the benefit of MSO and, as such, Kmart shall not at any time acquire any rights in the Licensed Property or otherwise by virtue of any use or exploitation Kmart may make thereof.

Id. at. 6. Respondent contends that it must respect the contract, which requires the payment of royalties to MSO, not Petitioner. Respondent argues that "[h]ad [Petitioner] wanted to avoid this situation, it could have easily dissolved MSO." *Id.* at 7.

Respondent further contends that when the ". . . royalty payments were transferred by MSO to [Petitioner], they lost their character as royalty payments." *Id.* As such, Respondent argues, it ". . . correctly classified the payments received by [Petitioner] from MSO as income." *Id.* at 8.

V. PETITIONER'S REPLY IN OPPOSITION TO RESPONDENT'S BRIEF IN OPPOSITION TO PETITIONER'S MOTION FOR SUMMARY DISPOSITION

Petitioner argues that Respondent does not ". . . dispute the fact that Petitioner continued to hold trademarks and develop additional trademarks for products under the License Agreement and failed to provide any legal authority whatsoever for its assertion that the Transferred Royalties were not royalties as defined by MCL 208.9(5)(g) and 208.9(7)(c)." Petitioner's Reply in Opposition to Respondent's Opposition, pp 1-2. Petitioner states that Respondent's ". . . Opposition Brief does not challenge or refute the fact that [Petitioner] owned and controlled the Stewart Property, and retained sole authority to have Stewart render personal services." *Id.* at 2. Petitioner argues that Respondent's Brief in Opposition also ignores the Court of Appeals determination in *Detroit Lions*.

VI. JOINT STIPULATION OF FACTS

1. "Petitioner, Martha Stewart Living Omnimedia, Inc. ('Petitioner') is a corporation whose current principal office is located at 601 West 26th Street, New York, NY 10001."

2. "This case concerns Respondent's proposed adjustments to Petitioner's Michigan Single Business Tax ('SBT') for tax years 2002 through 2006, as well as 2007."

3. "Respondent audited Petitioner for 2002 through 2005 (the 'Audit'), and as a result of the Audit issued Bill for Taxes Due (Final Assessment) R498801 alleging an SBT liability of $87,794.00 together with interest in the amount of $36,373.16 for a total purported liability of $124,167.16."

4. "As a result of the Audit, Respondent disallowed Petitioner's loss carryforward for 2006 and issued Bill for Taxes Due (Final Assessment) R764462 alleging SBT liability together with interest for a total purported liability of $9,338.52."

5. "As a result of the audit, Respondent disallowed Petitioner's loss carryforward for 2007 and issued Bill for Taxes Due (Final Assessment) R764734 alleging an SBT liability of $7,321.00 together with interest in the amount of $975.02 for a total purported liability of $8,296.02."

6. "On or about August 29, 2010 Petitioner paid Respondent $9,365.30 as payment of assessment R764462."

7. "The Audit proposed to increase Petitioner's SBT base due to the disallowance of certain royalty revenues paid by Kmart Corporation during the years 2002 through 2005."

8. "Petitioner is the owner of various trademarks utilizing the name 'Martha Stewart,' as well as the name, likeness, voice and signature of Martha Stewart (in each case solely in connection with the trademark) (the 'Stewart Property')."

9. "As a part of Petitioner's business, it licenses use of various trademarks, the Stewart Property and designs, and other intellectual property incorporated into numerous retail products to various retail stores."

10. "In 1997, 1998, and 1999, Petitioner entered into several agreements with Kmart Corporation, a Michigan corporation ('Kmart') for the use of the Stewart Property for the development and sale of various types of products and merchandise sold under the trade

name ‘Martha Stewart’ (collectively the ‘Prior Agreements’).”

11. “With the implementation of the Prior Agreements, Petitioner filed Michigan SBT returns and paid SBT tax liability.”

12. “On November 30, 2000 Petitioner formed a wholly owned subsidiary, MSO IP Holdings, Inc., a California corporation, (‘MSO’).”

13. “MSO issued 1,000 shares of stock (the ‘Stock’) to Petitioner in exchange for Petitioner’s contribution of some of Petitioner’s trademarks and retailer license agreements, including the Prior Agreements, under Section 351 of the Internal Revenue Code of 1986, as amended.”

14. “On or about June 13, 2002, MSO assigned its trademarks back to Petitioner, including the Everyday Garden Marks.”

15. “On or about June 21, 2002, a license agreement (the ‘License Agreement’) was entered into between MSO and Kmart, combining the terms of the Prior Agreements, consolidating them into a single agreement.”

16. “The License Agreement referenced the Prior Agreements, and included the Stewart Property as well [as] all trademarks utilizing ‘Martha Stewart Everyday.’”

17. “The Prior Agreements and the License Agreement all required Kmart to pay a royalty as consideration for certain services and use of the Stewart Property (the ‘Royalty Payment’).”

18. “The Royalty Payment, based on an agreed upon rate multiplied by aggregate retail sale prices charged by Kmart for licensed products sold, net any amounts actually refunded by Kmart to customers on account of returns of such products.”

19. “The Royalty Payment paid by Kmart was royalty as that term is used in MCL 208.9(5)(g).”

20. “All Royalty Payments under the Prior Agreements were recorded by Petitioner as royalty income, and deducted from its tax base on its SBT returns.”

21. “After execution of the License Agreement, Kmart remitted all Royalty Payments to MSO.”

22. “After execution of the License Agreement, MSO transferred all Royalty Payments to Petitioner (the ‘Transferred Revenues’).”

23. “All Transferred Revenues were recorded by Petitioner as royalty income, and deducted from its tax base on its SBT returns.”

24. “Respondent’s Audit Report of Findings stated that ‘[w]hen the income is transferred to [Petitioner] the income loses it [sic] identify [sic] as royalty income and the income becomes nothing more than miscellaneous revenue received from MSO IP Holding [sic] Inc. [Petitioner] cannot deduct this income as a royalty income subtraction on their [sic] SBT returns.’”

25. “Petitioner timely served written notice upon Respondent exercising its right to an informal conference pursuant to MCL 205.21.”

26. “An informal conference was held on May 18, 2010 (the ‘Conference’), before Sherry Hilpert, Hearing Referee, of Respondent’s Office of Hearings (the ‘Referee’).”

27. “At the Conference, Respondent contended the Transferred Revenues ‘become[s] nothing more than miscellaneous revenue received from’ MSO and is income.”

28. “The Referee determined that Petitioner’s ‘receipt of cash from MSO constitutes an economic benefit with an ascertainable fair market value. As such, the petitioner received taxable income that it is required to report on its federal taxable return.’”

29. “On August 19, 2010, Daniel M. Greenberg, Administrator of Respondent’s Office of Hearings, issued two Decisions and Orders of Determination agreeing with the Referee’s recommendations affirming Assessments R498801 and R764734.”

VII. STANDARD OF REVIEW UNDER MCR 2.116(C)(10)

A motion for summary disposition under MCR 2.116(C)(10) tests the factual support for a claim and must identify those issues regarding which the moving party asserts there is no genuine issue of material fact. Under subsection (C)(10), a motion for summary disposition will be granted if the documentary evidence demonstrates that there is no genuine issue of material fact, and the moving party is entitled to judgment as a matter of law. *Smith v Globe Life Insurance*, 460 Mich 446, 454-455; 597 NW2d 28 (1999). In the event, however, it is determined that an asserted claim can be supported by evidence at trial, a motion under subsection (C)(10) will be denied. *Arbelius v Poletti*, 188 Mich App 14; 469 NW2d 436 (1991).

In *Quinto v Cross & Peters Co*, 451 Mich 358, 362-63; 547 NW2d 314 (1996), the Michigan Supreme Court set forth the following standards for reviewing motions for summary disposition brought under MCR 2.116(C)(10):

> In reviewing a motion for summary disposition under MCR 2.116(C)(10), the trial court considers affidavits, pleadings, depositions, admissions and documentary evidence filed by the parties, MCR 2.116(G)(5), in the light most favorable to the party opposing the motion. A trial court may grant a motion for summary disposition under MCR 2.116(C)(10) if affidavits or other documentary evidence show there is no genuine issue in respect to any material fact and the moving party is entitled to judgment as a matter of law. MCR 2.116(C)(10), (G)(4).

The Michigan Supreme Court has established that a court must consider affidavits, pleadings, depositions, admissions, and documentary evidence filed by the parties in the light most favorable to the non-moving party. *Quinto v Cross & Peters Co*, 451 Mich 358, 362-63; 547 NW2d 314 (1996) (citing MCR 2.116(G)(5)). The moving party bears the initial burden of supporting his position by presenting his documentary evidence for the court to consider. *Neubacher v Globe Furniture Rentals*, 205 Mich App 418, 420; 522 NW2d 335 (1994). The burden then shifts to the opposing party to establish that a genuine issue of disputed fact exists. *Id*. Where the burden of proof at trial on a dispositive issue rests on a nonmoving party, the nonmoving party may not rely on mere allegations or denials in pleadings, but must go beyond the pleadings to set forth specific facts showing that a genuine issue of material fact exists. *McCart v J Walter Thompson*, 437 Mich 109, 115; 469 NW2d 284 (1991). If the opposing party fails to present documentary evidence establishing the existence of a material factual dispute, the motion is properly granted. *McCormic v Auto Club Ins Ass'n*, 202 Mich App 233, 237; 507 NW2d 741 (1992).

VIII. CONCLUSIONS OF LAW

This Tribunal has carefully considered Petitioner's Motion for Summary Disposition under the criteria for MCR 2.116(C)(10) and, based on the pleadings and other documentary evidence filed with the Tribunal, determines that granting Petitioner's Motion for Summary Disposition is appropriate. The Tribunal finds that there are no genuine issues with respect to any material facts regarding whether the income Petitioner received from MSO is royalty income. For the reasons set forth herein, Petitioner properly treated its revenue as royalty income and deducted it from the SBT tax base.

MCL 208.9 defined the tax base subject to the former Michigan SBT.[1] MCL 208.9(7)(c) permitted a taxpayer to deduct from its SBT tax base all royalties, to the extent included in arriving at federal taxable income. (This section of the statute excludes certain royalties that are not applicable in this case.) The SBT Act does not define the term royalty, although definitions and explanations are provided for certain specific types of royalties and franchise fees. See MCL 208.9(4)(g) and MCL 208.9(7)(c). The SBT Act did provide that "[a] term used in this act and not defined differently shall have the same meaning as when used in comparable context in the laws of the United States relating to federal income taxes in effect for the tax year unless a different meaning is clearly required." MCL 208.2(2).

The Michigan Supreme Court discussed the definition of royalties in the context of the SBT Act in several cases. The Court of Appeals held that there was no definition of royalty in the federal tax law used in a directly comparable context to the SBT Act. *Mobil Oil Corp, supra* at 484. The Supreme Court in *Mobil Oil Corp,* looked to extrinsic sources, including dictionaries, to help discern the meaning of the term royalties as used in the single business tax act. Further, the Courts are clear that the key characteristics of a royalty are that, "(1) it is a payment, (2) in the form of either a product itself or proceeds from the sale of the product, and (3) made in consideration of the use of the property." *Michigan United Conservation Clubs v Department of Treasury*, 239 Mich App 70, 79; 608 NW2d 141 (1999).

[1] The SBT was repealed by Act 325 of 2006, effective December 31, 2007.

The receipts involved in this matter are royalties. They easily fit within the definitions used by the Court in *Mobil Oil* and *Michigan United Conservation Clubs*. The income is "compensation or portion of the proceeds paid to the owner of a right" and "compensation for the use of property, usually copyrighted material . . . a share of product or profit reserved by owner for permitting another to use the property." *The Random House Dictionary* (rev ed), p 1150 and Black's Law Dictionary (5th ed), page 1195. Specifically, the payments Petitioner received are proceeds from the licensing of its intellectual property to its affiliated company, MSO. Further, the income is in consideration of the use of Petitioner's brand name and trademarks. Respondent does not contest that Petitioner retained the trademarks and developed additional trademarks utilized by Kmart under the terms of the Licensing Agreement between Kmart and MSO.

Respondent asserts that the payments by Kmart to MSO are royalty receipts; therefore, the payments made by MSO to Petitioner cannot be royalty receipts. In fact, Respondent merely contends that the income is "miscellaneous income" and states that "[w]hat the payments are called is not critical, since income for SBT purposes is based on federal taxable income, which includes all income from any source." Respondent's Brief in Opposition to Petitioner's Motion for Summary Disposition, p 7.

In *Detroit Lions*, a licensing agreement was set up between television networks and the football team in regard to live sports broadcast rights. The Detroit Lions football team is a franchised member of the National Football League ("NFL") and received a share of the NFL's television revenue, as well as NFL revenues generated by post-season games, which took place outside Michigan. The royalties were paid directly to the NFL for the broadcast of the football games. The Detroit Lions received a portion of these royalties from the NFL. The Court of Appeals stated that ". . . in order to constitute a sale, absolute ownership over the subject of the transaction must be passed." (citing *Central Discount Co v Department of Revenue*, 355 Mich 463, 467; 94 NW2d 805 (1959)). The Court of Appeals further stated that "a license to use and exploit, under certain terms and conditions, the product assembled by the NFL, we believe the transaction cannot be characterized as a 'sale.' Rather, we believe the payments received by the plaintiff in connection with the arrangement between the NFL and the networks should be classified as royalties as that term is used in MCL 208.9(7)." *Id* at 218-219.

The facts of the instant case are parallel to the facts of *Detroit Lions*. Petitioner received royalties that were transferred to it from MSO. Petitioner retained control and ownership over the intellectual property and the payments were compensation paid to an owner (i.e., Petitioner) of a right or property (Martha Stewart brand) for the use of such right or property. See *Mobil*, *supra*. MSO possessed the right to use Petitioner's intellectual property. The Tribunal is unconvinced by Respondent's argument that when royalty payments were transferred by MSO to Petitioner, they lost their character as royalty payments. Rather, MSO assigned the Martha Stewart trademarks back to Petitioner on or about June 13, 2002. As such, for the tax years at issue, Petitioner owned the trademarks and allowed MSO the right to use them. Petitioner clearly retained control and ownership over the trademarks and, thus, the payments made by MSO to Petitioner were royalty receipts, by definition.

The Tribunal finds that there is no genuine issue as to any material fact and, as such, summary disposition is appropriate in this matter. Further, the Tribunal has considered the affidavits, pleadings, depositions, admissions, testimony, and documentary evidence filed by the parties, and in the light most favorable to the party opposing the Motion, finds that Petitioner's Motion for Summary Disposition should be granted and the subject assessments shall be cancelled.

IX. JUDGMENT

IT IS ORDERED that Petitioner's Motion for Summary Disposition is GRANTED.

IT IS FURTHER ORDERED that Assessment Nos. R498801 and R764734 are CANCELLED.

This Opinion and Judgment resolves all pending claims in this matter and closes this case.

MICHIGAN TAX TRIBUNAL

Entered: August 18, 2011 By: Cynthia J Knoll