BF&R Docket No.	2403677
Petition Filed:	8/20/2024
ID No.	[redacted]
IN RE:	WESTERN DIGITAL TECHNOLOGIES INC
PETITION FOR	Review for Corporate Net Income Tax
PERIOD(S)	6/30/2021

AND NOW, December 5, 2024, pursuant to the Fiscal Code, the Act of 1929, April 9, P.L. 343, as amended, (72 P.S. § 1 et seq), the Board of Finance and Revenue of the Commonwealth of Pennsylvania, based upon the reasons set forth herein, hereby ORDERS the following:

Jurisdiction

This matter is before the Board of Finance and Revenue pursuant to Section 2704 of the Tax Reform Code of 1971, *as amended*, 72 P.S. § 9704.

Issues

Whether the Department of Revenue add-back of intangible expenses to Petitioner's taxable income was erroneous?

Whether Petitioner established that the intangible expenses paid to affiliates were arms-length transactions and not for the purpose of avoiding taxation in Pennsylvania?

Whether Petitioner is entitled to special apportionment removing I.R.C. § 367(d) royalties from taxable income because they do not represent fairly or accurately the extent of Petitioner's Pennsylvania business activities?

Statement of the Case

Petitioner, Western Digital Technologies, Inc., requests reassessment of its Pennsylvania corporate net income tax for the year ended June 30, 2021, excluding the intangibles added to Petitioner's taxable income at assessment.

Petitioner is a Delaware corporation with headquarters in California. Petitioner is a wholly owned subsidiary of Western Digital Corporation ("WDC"). WDC is the parent of a worldwide affiliated group of companies ("the WD Group"), which are collectively "engaged in the business of designing, developing, manufacturing and distributing data storage solutions."

Mailed: JUSTIN CUPPLES
MORGAN LEWIS & BOKLIUS LLP
2222 MARKET STREET
PHILADELPHIA, PA 19103
on December 16, 2024

TPL/sb

EX. CAL. NO. 8

On July 15, 2016, Petitioner transferred % of the issued and outstanding stock shares in SanDisk Corporation ("SDC") to SD International Holdings Ltd. ("Foreign SD"), Petitioner's wholly owned subsidiary incorporated in the Cayman Islands and treated as a controlled foreign corporation ("CFC") for Federal income tax purposes. On July 18, 2016, SDC converted to a Delaware limited liability company ("LLC"). Petitioner explains that the contribution of SDC to Foreign SD and the conversion of SDC to an LLC qualify as an I.R.C. § 368(a)(1)(F) reorganization or an "F reorg." An F reorg. treats SDC as having transferred all assets and liabilities to Foreign SD including all intangible property, goodwill, and going concern. Such a transfer to a foreign entity involves a deemed royalty payment from SD to Petitioner under I.R.C. § 367(d). This reorganization centralized ownership of intellectual property and reduced the number of legal entities in WDC's corporate structure.

Petitioner purchased products from SanDisk Manufacturing Unlimited Company (SDM) under a distribution agreement so that Petitioner had finished SanDisk products to sell in the Americas market. This arrangement is attributable to the unique manufacturing skills SDM has that Petitioner does not.

Petitioner filed its corporate report for the year ended June 30, 2021, with the Pennsylvania Department of Revenue claiming a $ corporate net income tax liability. This tax was calculated with a $ adjusted income apportioned by a factor of . or (sales) less a $ net loss deduction.

At assessment after audit, the Department of Revenue increased Petitioner's corporate net income tax to $ by decreasing a depreciation deduction, disallowing an "other" deduction and disallowing an "other" addition. Line 1 Federal income, the dividend deduction, the net income tax and bonus depreciation additions were accepted as reported. A $ depreciation deduction was decreased to $. The auditor disallowed a $ "other deduction." A $ "other addition" was disallowed. There was no record of any remaining net losses, so the reported net loss deduction was disallowed. The auditor decreased the sales factor to . or .

Petitioner protested the assessment adjustments in a reassessment case filed at the Board of Appeals (BOA), but the BOA denied relief. Petitioner explained it filed as part of a consolidated federal corporate income tax return for its fiscal year that ended June 30, 2021. On its Federal return, Petitioner included deemed royalty income from the F reorg. Petitioner included the costs of products purchased from SDM an Irish affiliate of Petitioner, as part of its cost of goods sold. Petitioner subtracted the I.R.C. 367(d) royalty from its taxable income.

Petitioner explained throughout this tax period SDM licensed intellectual property from and paid royalties to Foreign SD. Petitioner stated these royalty payments were paid entirely outside of the United States an agreement between SDM and Foreign SD (license agreement). Petitioner stated it was not a party to the agreement and its principal purpose was for SDM to obtain the right to use certain of Foreign SD's intangible property, trademarks and trade dress in order to manufacture and sell products. Petitioner stated the payment for these royalties was done at arm's length and in accordance with the transfer pricing study. During this tax period, Petitioner noted SDM sold products to Petitioner pursuant to a distribution agreement.

The agreement noted it was between SanDisk Manufacturing Limited and Petitioner, and that SanDisk Manufacturing Limited converted to SanDisk Manufacturing Unlimited in October 2016. Petitioner contended the principal purpose for this distribution agreement and the transactions was for Petitioner to purchase finished SanDisk products manufactured by SDM and sell them in the American market. Petitioner stated SDM was a foreign manufacturer that possessed unique manufacturing skills and resources. Petitioner argued it was a domestic sales and distribution company that possessed sales and distribution networks, resources SDM did not have. The distribution agreement, argued Petitioner, represented a reasonable exchange of value between SMD and Petitioner. Further, Petitioner maintained the pricing for the sale of products by SDM to Petitioner was done at arm's length in accordance with a transfer pricing study.

Petitioner objected to the Department disallowance of its deduction for the I.R.C.§ 367(d) royalty. Petitioner contended Petitioner's exclusion of I.R.C. § 367(d) was mandated by the foreign commerce clause of the United States Constitution. Petitioner stated under I.R.C. § 368(a)(1) seven different forms of entity reorganization are described, and under an F reorg. included "a mere change in identity, form or place of reorganization of one corporation, however effected" and deemed a "F Reorg." Further, under I.R.C. § 361(a), Petitioner noted this provided there is no gain or loss recognition for a corporation that was a party to a reorganization and exchanged property, in pursuance to the reorganization, solely for stock or securities in another corporation that is a party to the reorganization. Petitioner stated the Tax Reform Code conformed to I.R.C. § 368(a)(1)(F), I.R.C. § 361(a), and I.R.C. § 367(d). Petitioner then argued Courts have held a state's habitual repeated conformity to the I.R.C. is unconstitutional when such conformity resulted in a disparate taxation of domestic and foreign commerce. Petitioner cited to Kraft General Foods v. Iowa Dept. of Revenue, 505 U.S. 71 (1992), and Dart Industries, Inc. v. Clark, 657 A.2d 1062 (R.I. 1995). Petitioner claimed that with its conformity to I.R.C. § 367(d), Pennsylvania imposed tax on royalties paid by a foreign affiliate but did not impose tax on royalties paid by a similarly situated domestic affiliate. Petitioner argued its case was similar to these cases in Iowa and Rhode Island in that Pennsylvania also employed a separate company reporting regime and did not have a foreign tax credit mechanism. Petitioner argued Pennsylvania law did not prevent its disparate treatment of domestic and foreign commerce under I.R.C. § 367.

Petitioner maintained the I.R.C. § 367(d) royalties must be excluded from its corporate net income tax base because it did not result in a tax that fairly or accurately reflected Petitioner's business in Pennsylvania. Petitioner stated the United States Supreme Court has long granted relief to taxpayers under the Due Process and Commerce Clauses when a state tax produced a result that did not fairly or accurately reflect a business in the state. Petitioner cited to *Hans Rees' Sons, Inc. v. State of North Carolina,* 283 U.S. 123 (1991), where Petitioner stated the Court determined a single factor apportionment method created an unconstitutional level of distortion for the Petitioner. Petitioner further cited Norfolk & Western Railway Co., v. Missouri State Tax Comm., 390 U.S. 317 (1968). Petitioner noted the Court similarly struck down a tax that distorted taxpayer's presence in the state. In this case, Petitioner argued the employment of an alternative apportionment method excluded I.R.C. § 367(d) royalties was necessary to avoid an unconstitutional level of distortion. According to Petitioner, the royalties had no connection to Pennsylvania. Petitioner maintained they are

deemed royalties from an entity organized outside the United States to a domestic corporation organized in Delaware and headquartered/domiciled in California. Petitioner explained the royalties were triggered by Petitioner's contribution of a domestic corporation organized in Delaware and headquartered/domiciled in California to Foreign SD. Petitioner maintained none of the activities were connected to Petitioner's business in Pennsylvania. Petitioner argued the Department's inclusion of this income in Petitioner's corporate net income tax base increased its Pennsylvania tax by ███% from Petitioner's tax base as originally filed.

Petitioner argued the intangible add-back was erroneous because the relevant transactions were done at arm's length and their principal purpose was not the avoidance of corporate net income tax. Petitioner contended the Tax Reform Code of 1971 provided there shall be no deduction for an intangible expense incurred directly or indirectly in connection with a transaction with an affiliated entity. Petitioner stated the Tax Reform Code further provided a taxpayer may deduct intangible expenses in connection with a transaction with an affiliate if the transaction (1) did not have as the principal purpose the avoidance of Pennsylvania CNIT, and (2) was done at arm's length rates and terms. Petitioner maintained its purpose of products from SDM did not include an intercompany intangible expense and argued the distribution agreement specifically stated, with very limited use-based exceptions for marketing purposes, Petitioner shall acquire no rights whatsoever in, or to, manufacturing IP or product IP.

Petitioner argued the pricing of the purchases under the distribution agreement was done at arm's length, pursuant to a transfer pricing study. Petitioner contended it is not a party to or beneficiary of the license agreement, the agreement laid out formal, arm's length terms between Foreign SD and SDM, and the pricing of the royalties under the license agreement was done at arm's length. Petitioner further stated the principal purpose of the transactions was not the avoidance of Pennsylvania corporate net income tax. As described in the distribution agreement, the purpose of the transactions was for Petitioner to purchase finished SanDisk products manufactured by SDM and to distribute and sell them in the American market. Petitioner maintained, WDT and SDM were separate entities and performed different functions under the distribution agreement- Petitioner served a sales and distribution function and SDM served a manufacturing function. According to Petitioner, the distribution agreement between the entities reflected a mutually beneficial arm's length commercial exchange. As for the license agreement, Petitioner argued the principal purpose was for SDM to obtain the right to use certain of Foreign SD's intangible property, trademarks, and trade dress in order to manufacture and sell products. Petitioner included the following exhibits with its BOA petition: transaction illustration as to the F reorganization, Petitioner's Federal Consolidated return, Petitioner's RCT-101, the license agreement between SanDisk Corporation and SanDisk Manufacturing, SanDisk transfer pricing study, the distribution agreement between SanDisk Manufacturing Limited and Petitioner, and Petitioner's transfer pricing study.

The BOA sustained the assessment in its entirety. The BOA stated under 72 P.S. § 7401(3)1.(t)(1), "Except as provided in paragraph (2), (3) or (4) for taxable years beginning after December 31, 2014, and in addition to any authority the department has on the effective date of this paragraph to deny a deduction related to a fraudulent or sham transaction, no deduction shall be allowed for an intangible expense or cost, or an interest expense or cost, paid, accrued or incurred directly or indirectly in connection with one or more transactions with

an affiliated entity." The BOA found the inclusion of a portion of the royalties SanDisk Manufacturing Unlimited Company paid to SD International Holdings Ltd. were included as embedded royalties. The BOA stated this was prorated in direct proportion to the product sales SDM made to Petitioner in accordance with Information Notice Corporation Taxes 2016-01 and the intangible expense statute which reads, "no deduction shall be allowed for an intangible expense or cost, or an interest expense or cost, paid, accrued or incurred directly or indirectly in connection with one or more transactions with an affiliated entity." The BOA found the adjustment made for the intangible expense add-back was only for a portion of royalties embedded within the cost of goods transferred from SDM to the Petitioner in the United States. The BOA noted the portion of the royalties included in the cost of sales to others was not included in the add-back. The BOA found SDIH is domiciled in a foreign dependency of the United Kingdom, therefore not a sovereign nation nor does the foreign dependency have a comprehensive income tax treaty with the United States. Further, the BOA found it was the Department's position the economic position of the parties involved in this arrangement were not improved apart from avoidance of Pennsylvania corporate net income tax; it did not follow the distribution agreement between the related parties required the payment of intercompany royalties between them for any other reason except for tax avoidance. The BOA also found Petitioner had not provided any evidence for an allowed deduction for royalty income and found the deduction was not allowed under the Tax Reform Code.

Petitioner files the instant matter at the Board of Finance and Revenue. Petitioner raises the same arguments it raised at the BOA. Petitioner argued the assessment violated the Equal Protection Clause of the United States Constitution and the Uniformity Clause of the Pennsylvania Constitution. Petitioner included the same exhibits as it did at the BOA.

Conclusion

Petitioner's request for relief is denied.

The taxable income used in the corporate net income tax calculation starts with the amount of separate company taxable income reported as taxable income to the Federal government, subject to correction for fraud, evasion or error; usually Federal taxable income before special deductions and net operating losses. See 72 P.S. § 7401(3)1.(a) and (t)(1); see also 61 Pa. Code § 153.11. In appeals before this Board, the burden of proof shall be on the petitioner. See 72 P.S. § 9705.

Petitioner's claim for the royalty deduction is denied. Petitioner has not met its burden of proof under the statute to show it is entitled to a deduction for its "other income" in the amount. Petitioner argued under case law that courts have held a state's conformity to the I.R.C. was unconstitutional and resulted in disparate taxation of domestic and foreign commerce. However, Petitioner has not proven it was entitled to this deduction or that the royalties lacked any connection to Pennsylvania. Petitioner has not proven the sales factor gross royalties should not have been adjusted by the Department.

As to Petitioner's claim for the intangible expenses related to SDM embedded royalties, this is denied. Petitioner has not sufficiently proven the types of transactions Petitioner

engaged in served an economic purpose. See Pitti v. Pocono Business Furniture, Inc., 859 A.2d 523, 527 (Pa. Commw. 2004) (finding two mortgages recorded against a property were "sham transactions" where the mortgages had nothing to do with securing payment from an indebted mortgagor and the mortgages had no practical function and provided no economic substance; defining "sham transaction" as "an agreement or exchange that has no independent economic benefit or purpose and is entered into solely for some illegitimate purpose, typically to avoid tax obligations;" and holding for a transaction to avoid being designated a "sham transaction" "there must be a 'genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached….'"), citing Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978). Petitioner identified the distribution agreement between SDM and itself as support for having economic substance and a principal purpose. However, Petitioner has not provided sufficient proof of business operations by the related entities, SDM or SDIH, which may have included, but are not limited to, real estate, salaries, or employees. Additionally, Petitioner did not provide any tax documents for SDM or SDIH. In fact, both are foreign companies. Petitioner has not sufficiently proven to this Board that tax avoidance was not the principal purpose of its arrangements with SDM.

Petitioner's request for special apportionment is denied because Petitioner has not provided sufficient evidence showing that the included royalties failed to fairly represent the extent of Petitioner's business activities in Pennsylvania. See 72 P.S. § 7401(3)2.(a)(18).

As to Petitioner's challenge to the validity and/or constitutionality of the statutes at issue, the Board of Finance and Revenue cannot decide whether a Pennsylvania statute is unconstitutional. See Parsowith v. Commonwealth of Pennsylvania Department of Revenue, 555 Pa. 200, 723 A.2d 659 (1999); Land Holding Corp. v. Board of Finance and Revenue, 388 Pa. 61, 130 A.2d 700 (1957). Petitioner has not presented sufficient details or evidence supporting claims that the Department's application of Pennsylvania law to this case violated the United States or Pennsylvania Constitutions. See 72 P.S. § 9705.

Accordingly, this Board enters the following:

ORDER

This petition is denied.

By Order Of The Board Of Finance And Revenue

Jacqueline A. Cook, Chair
Designee for Stacy Garrity, State Treasurer

David R. Kraus, Board Member

Paul J. Gitnik, Board Member