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TAX APPEAL COURT
Aug. 8. 305 pm '85
Curt

IN THE TAX APPEAL COURT OF THE STATE OF HAWAII

IN THE MATTER OF THE TAX)	CASE NO. 2232
APPEAL)	
)	FINDINGS OF FACT AND
OF)	CONCLUSIONS OF LAW;
)	JUDGMENT
McDONALD'S RESTAURANTS OF)	
HAWAII, INC., as the)	
successor in interest of)	
McDONALD'S OF HAWAII)	
MANAGEMENT CORPORATION)	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This case was presented by stipulations of fact filed herein on February 19, 1985 and on May 17, 1985, by concurrent opening and answering briefs, and by oral argument before the Honorable Edwin H. Honda on May 17, 1985. Edward Y. C. Chun represented the Taxpayer and Kevin T. Wakayama represented the Director. The Court has examined the pleadings, stipulations, exhibits, and briefs, and has heard the arguments of counsel. The Court states the question presented as follows:

A TRUE COPY, ATTEST WITH
THE SEAL OF SAID COURT.

BARBARA E. WRIGHT

Clerk

QUESTION PRESENTED

1. Is there an intermediary service relationship between Taxpayer (management service provider), McDonald's Corporation (intermediary), and McDonald's restaurants (customer) within the meaning of HRS § 237-13(6)? If so, Taxpayer is subject to the 1/2% general excise tax rate; if not, Taxpayer is subject to the 4% rate.

a. Is McDonald's Corporation a taxpayer engaged in a service business?

b. Does McDonald's Corporation act in the nature of an intermediary between the restaurants and Taxpayer?

c. Who is the ultimate recipient of the benefits of Taxpayer's management services, is it McDonald's Corporation or the restaurants?

THE COURT HEREBY MARES AND ENTERS THE FOLLOWING
FINDINGS OF FACT AND CONCLUSIONS OF LAW:

FINDINGS OF FACT

1. Appeal. Taxpayer has timely appealed from the general excise tax assessments for calendar years 1978, 1979, 1980, and 1981. Taxpayer contends that these assessments are partially invalid because it is providing management services to its customers (McDonald's restaurants) at the request of an intermediary (McDonald's Corporation), and therefore qualifies for the 1/2% general excise tax rate under HRS § 237-13(6). The amount of taxes in controversy is \$202,056.09, plus interest.

2. Description of Characters. This case concerns the relationships between and among (a) McDonald's Corporation, (b) the McDonald's restaurants in Hawaii, and (c) the Taxpayer (McDonald's of Hawaii Management Corporation) for the tax years 1978 through 1981. McDonald's Corporation is the largest fast-food franchisor in the world. The McDonald's restaurants in Hawaii are licensees of the "McDonald's System" and are either wholly owned subsidiaries of McDonald's Corporation or are not related to McDonald's Corporation. Stipulation of Facts filed herein on February 19, 1985 ("SOF") ¶1. For the years in question, the Taxpayer was a wholly owned subsidiary of McDonald's Corporation. Taxpayer contracted with McDonald's Corporation to provide management services to the McDonald's restaurants in Hawaii on behalf of, and as agent of, McDonald's Corporation. SOF ¶ 5 and 6.

In this decision, McDonald's Corporation is sometimes referred to as "McDonald's" and the McDonald's restaurants are sometimes referred to as the "restaurants".

3. Nature of License between McDonald's Corporation and McDonald's restaurants.

a. McDonald's Corporation licenses the use of its restaurant system to its McDonald's restaurants. The License Agreement describes the restaurant system and the nature of the license as follows:

A. McDonald's Corporation, a Delaware corporation ("McDonald's") has developed and operates a restaurant system ("McDonald's System"). The McDonald's

System includes proprietary rights in certain valuable trade names, service marks and trademarks, including the trade names "McDonald's" and "McDonald's Hamburgers," designs and color schemes for restaurant buildings, signs, equipment layouts, formulas and specifications for certain food products, methods of inventory and operation control, bookkeeping and accounting, and manuals covering business practices and policies. The McDonald's System is operated and is advertised widely within the United States of America and in certain foreign countries.

B. Licensor holds the right to grant licenses for the adoption and use of the McDonald's System at the location hereafter described.

C. Licensee desires to acquire the right to adopt and use the McDonald's System in a restaurant at the location specified in this License.

Therefore, in consideration of the privilege of conducting a restaurant business under this License, and the mutual obligations contained herein, the parties agree as follows:

1. Interpretation. The McDonald's System is a comprehensive restaurant system for the retailing of a limited menu of uniform and quality food products, emphasizing prompt and courteous service in a clean, wholesome atmosphere which is intended to be attractive to children and families. The foundation of the McDonald's System and the essence of this License is the adherence by Licensee to standards and policies of Licensor providing for the uniform operation of all McDonald's restaurants within the McDonald's System including, but not limited to, serving only designated food and beverage products; the use of only prescribed equipment and building layout and designs; strict adherence to designated food and beverage specifications and to Licensor's prescribed standards of quality, service and cleanliness in Licensee's restaurant

operation. Compliance by Licensee with the foregoing standards and policies in conjunction with the McDonald's trademarks and service marks provides the basis for the valuable good will and wide family acceptance of the McDonald's System. Moreover, the establishment and maintenance of a close personal working relationship with the Licensee in the conduct of his McDonald's restaurant business, his accountability for performance of the obligations contained in this License, and his adherence to the tenets of the McDonald's System constitute the essence of this License.

(a) The provisions of this License shall be interpreted to give effect to the intent of the parties stated in this paragraph 1 so that the restaurant specified in this License shall be operated in conformity to the McDonald's System through strict adherence to Licensor's standards and policies as they exist now and as they may be from time to time modified.

License Agreement, pp. 1 and 2, attached to SOF as Exhibit 1.

b. The McDonald's restaurants pay a service fee equal to 3% of their gross sales. The service fee is paid twice a month. The License Agreement states that the service fee is "in consideration of licensor's services" and in "consideration for the grant of this license." License Agreement, p. 4.

c. The restaurants pay the service fee for the use of the license and for ancillary services performed by McDonald's Corporation in Illinois.

"In substance, the service fee of 3% paid by Hawaii stores is a periodic payment in exchange for the use of the McDonald's "System" which was developed outside the

State of Hawaii and continues to be enhanced at our headquarters in Oak Brook, Illinois. The services provided to the stores in Hawaii, including product and equipment development, are all initiated and formulated in Oak Brook. Hawaii Management Co. [Taxpayer], one of the companies included in your audit, then communicates these updates in the system to the stores."

Letter dated May 24, 1983 from Thomas E. Fremgen, State Tax Counsel for McDonald's Corporation, to Melvin Wakumoto, Tax Auditor, attached to SOF as Exhibit 4.

"In summary, we continue to assert that . . . the services creating the [service fee] income are performed in Illinois."

Letter dated July 28, 1983 from Thomas E. Fremgen to Melvin Wakumoto, attached to SOF as Exhibit 4.

4. Description of Taxpayer's "Management Services" for McDonald's.

a. For the tax years under appeal, McDonald's Corporation engaged Taxpayer to perform management services on behalf of, and as agent of, McDonald's Corporation. The Management Services Agreement describes the management services, and the relationship between the parties, as follows:

ARTICLE II - SCOPE OF SERVICES

McDonald's hereby engages Management and Management hereby agrees to perform for McDonald's to the best of its ability in a faithful and diligent manner [a] such general supervisory services with respect to the management of the Restaurants as may from time to time be required, and as are necessary and appropriate for the efficient and economical operation and management of the Restaurants, [b] as well as those contractual obligations and duties with respect to the operation of the Restaurants

as may be required pursuant to the terms and provisions of the relevant License Agreements

. . . .

ARTICLE VII - RELATIONSHIP

In the performance of this Agreement, Management shall be deemed to be an agent of McDonald's, its authority limited to the scope specified in Article II, above.

Management Services Agreement, pp. 2 and 4, attached to SOF as Exhibit 2.

b. McDonald's Corporation characterizes Taxpayer's (a) general supervisory services and (b) contractual obligations under the License Agreements, as: (a) oversight of restaurant operations, (b) quality control of products and (c) communication of updates in the McDonald's System to the restaurants.

"There are several other corporations in Hawaii, also examined in your audit, which oversee the restaurant operations. For example, McDonald's Hawaii Management Co. employees are responsible for the quality of products."

Letter dated July 28, 1983, Fremgen to Wakumoto, attached to SOF as Exhibit 4.

"Hawaii Management Co., one of the companies included in your audit, . . . communicates these updates in the [McDonald's] system to the stores."

Letter dated May 24, 1983, Fremgen to Wakumoto, attached to SOF as Exhibit 4.

CONCLUSIONS OF LAW

A. McDonald's Corporation (the intermediary) is not a taxpayer engaged in a service business; and therefore the intermediary service provision (HRS § 237-13(6)) does not apply to Taxpayer's situation.

1. Taxpayer contends that it should be taxed at the 1/2% general excise tax rate because an intermediary service relationship exists between the McDonald's restaurants (customers), McDonald's Corporation (intermediary), and Taxpayer (service provider). In pertinent part, HRS § 237-13(6) provides:

"[W]here any person [Taxpayer] engaging or continuing within the State in any service business or calling renders such services upon the order of or at the request of another taxpayer [McDonald's Corporation] who is engaged in the service business and who, in fact, acts as or acts in the nature of an intermediary between the person rendering such services and the ultimate recipient of the benefits of such services, so much of the gross income as is received by the person rendering the services shall be subjected to the tax at the rate of one-half of one per cent"

HRS § 237-13(6) expressly requires that the intermediary be "another taxpayer who is engaged in the service business."

2. The Director contends that Taxpayer should be taxed at the 4% general excise tax rate because McDonald's Corporation (the intermediary) is not a taxpayer engaged in a service business as required by HRS § 237-13(6), and therefore the intermediary service provision does not apply.

3. McDonald's Corporation is a taxpayer engaged in the business of franchising its McDonald's System through License Agreements. The License Agreements provide that the McDonald's restaurants shall have the right, license and privilege to use the McDonald's System at a certain location for 20 years. Ancillary to the grant of the license, the License Agreements provided that McDonald's Corporation (a) shall "advise and consult" with the licensees in connection with the operation of the restaurants, and (b) shall "communicate . . . its know-how, new developments, techniques and improvements in areas of restaurant management, food preparation, and service which are pertinent to the operation of a restaurant using the McDonald's System." License Agreement, p. 2, SOF Exhibit 1.

McDonald's is in the business of selling the privilege to use a fast-food restaurant system for a certain time at a particular place. This business of selling privileges is clearly a franchising or licensing business, as opposed to a service business.

4. McDonald's franchising or licensing business is not a service business. Taxpayer argues that McDonald's contractual duties to "advise and consult" and "communicate" constitute a service business. These duties are (a) ancillary to McDonald's licensing business and (b) do not constitute a separate service business. Almost every business activity includes some type of ancillary services. For example,

shopping center leases generally provide that the lessor shall provide janitorial, security, and shopping center management services. These ancillary services do not (a) change the leasing business into a service business, or (b) constitute a separate service business.

5. Furthermore, the facts show that McDonald's only business in Hawaii is licensing local franchise rights, and that McDonald's does not in fact perform any services in Hawaii.

"Since its qualification [to do business in Hawaii], McDonald's Corporation has had no employee in the State of Hawaii, nor did it own or rent any property within the State [except a vacation condominium]

....

....

"In substance, the service fee of 3% paid by Hawaii stores is a periodic payment in exchange for the use of the McDonald's "System" which was developed outside the State of Hawaii and continues to be enhanced at our headquarters in Oak Brook, Illinois. The services provided to the stores in Hawaii, including product and equipment development, are all initiated and formulated in Oak Brook."

Letter dated May 24, 1983 from Fremgen to Wakumoto, SOF Exhibit 4.

"In summary, we continue to assert that . . . the services creating the [service fee] income are performed in Illinois."

Letter dated July 28, 1983 from Fremgen to Wakumoto, SOF Exhibit 4.

6. Since McDonald's does not perform any services in Hawaii, it cannot be a "taxpayer who is engaged in the service

business" in Hawaii. McDonald's therefore, is taxed as a taxpayer engaged in the licensing business in Hawaii.

In re Heftel Broadcasting Honolulu, Inc., 57 Haw. 175 (1976), held that income from a licensing business (the business of licensing telecast rights) was taxable as "other business" under HRS § 237-13(10) (rather than as "service business" under HRS § 237-13(6)). Note that the question of whether the business was licensing or services was never raised in the case.

7. For the above reasons, McDonald's is not a taxpayer engaged in a service business, and therefore the intermediary service provision does not apply to Taxpayer's situation.

B. McDonald's Corporation does not act in the nature of an intermediary between the McDonald's Restaurants and Taxpayer; and therefore the intermediary service provision (HRS § 237-13(6)) does not apply to Taxpayer's situation.

8. HRS § 237-13(6) expressly requires that the Taxpayer render its management services at the request of another taxpayer (McDonald's Corporation) who "acts in the nature of an intermediary between the person rendering such services and the ultimate recipient of the benefits of such services." For purposes of this section, an intermediary is a "taxpayer who is a mere conduit for the service en route to the ultimate recipient, the customer." In re Busk Enterprises, Inc., 53 Haw 518, 521 (1972); and In re Pacific Laundry Co.,

Ltd., T.A. No. 1864 (Decision and Order filed January 14, 1980), affirmed 65 Haw. 678 (1982).

9. An "intermediary" is generally defined as follows:

"An arbitrator or mediator. A broker; one who is employed to negotiate a matter between two parties, and who for that purpose may be agent of both; e.g. insurance broker. See also Finder."

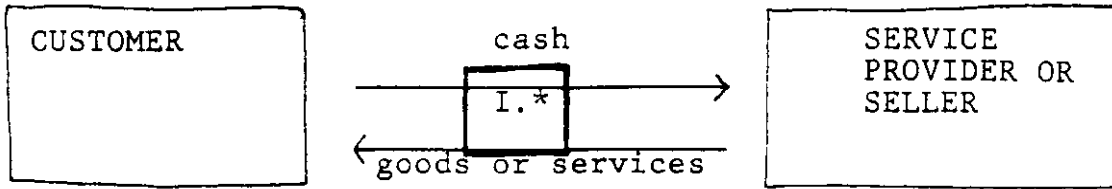
Black's Law Dictionary (fifth ed. 1979).

"1: one that is intermediate: a: MEDIATOR, INTERAGENT, GO-BETWEEN (. . . between the people and God) b: something that serves as a medium or means: mediating agency 2: an intermediate form, stage, or product."

Webster's Third New International Dictionary (unabridged 1967).

10. Under the above definitions, an "intermediary" is a person who is a mere conduit or go-between between the two principal parties: the customer on the one hand, and the seller or service provider on the other. By definition, an intermediary can never be a principal party. If the intermediary was a principal party, it would no longer be an intermediary. Therefore an intermediary cannot be the service provider or the seller.

11. A transaction involving an intermediary can be diagrammed as follows:



*Intermediary arranges sale and is conduit for the cash.

12. HRS § 237-18(c) (prior to 1971), which is the predecessor to HRS § 237-13(6), expressly provided for three examples of intermediary services which qualify under HRS § 237-13(6). See In re Busk Enterprises, Inc., 53 Haw. 518 (1972).

<u>Customer</u>	<u>Intermediary</u>	<u>Service Provider</u>
1. Customer	service station	tire recapper
2. Customer	body and fender shop	auto paint shop
3. Customer	photo studio	photo printer

In all cases, the intermediary merely arranges for the service and is a conduit for the payment. The intermediary is not the service provider, and indeed is not capable of performing the service which the customer requests.

13. The facts show that McDonald's Corporation is not an intermediary between the restaurants and the Taxpayer. The restaurants license McDonald's fast-food system. Ancillary to the use of the license, the restaurant's request that McDonald's provide consulting and communication services in order to set up and update McDonald's fast-food system. The restaurants are contracting with and looking to McDonald's to provide this service, and to no other person. Indeed, no other

person could perform these services which are inseparable from the McDonald's System itself. In this relationship, McDonald's is clearly the service provider, because no one else could perform these services.

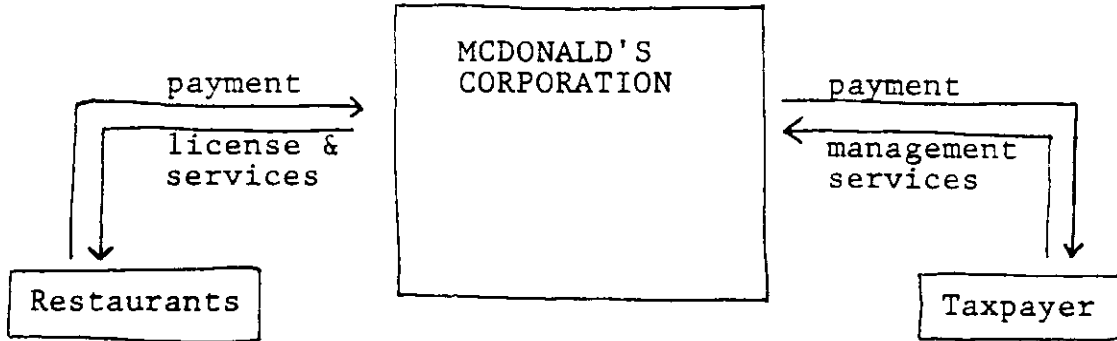
It can reasonably be assumed that McDonald's would never entrust the McDonald's System or its most recent improvements to an independent third party service provider. The fast-food business is highly competitive and innovations and improvements in the system are closely guarded.

14. McDonald's fulfilled part of its license obligation to provide consulting and communication services to the restaurants through the Taxpayer. Taxpayer was not the service provider, however, it was merely the agent of the service provider. McDonald's Corporation at all times was fully liable under the license Agreements to provide these services to the restaurants. Taxpayer did not assume these obligations in place of McDonald's, but only contracted with McDonald's to perform these services on behalf of McDonald's as McDonald's agent.

15. The relationship between the restaurants, McDonald's and Taxpayer can be summarized as follows:

<u>Restaurants</u>	<u>McDonald's</u>	<u>Taxpayer</u>
1. licensee	licensor/principal	agent
2. customer	service provider/ principal	agent
3. contract obligee	contract obligor	subcontractor
4. subsidiaries and independents	parent corporation	subsidiary

16. The relationship between the restaurants, McDonald's and Taxpayer can be diagrammed as follows:



17. McDonald's Corporation is the sole principal party in this relationship. The restaurants depend heavily upon McDonald's Corporation, and indeed owe their very existence to the McDonald's Corporation. They are merely distribution outlets for the McDonald's Corporation; they are not principal parties in this relationship. The Taxpayer is McDonald's wholly-owned subsidiary, and by contract can only act as its agent to perform certain services on behalf of McDonald's. Taxpayer is not a principal party in this relationship, and indeed is almost indistinguishable from McDonald's. McDonald's Corporation is clearly not an intermediary or a conduit between the restaurants and the Taxpayer. Rather, the restaurants and the Taxpayer are conduits of the McDonald's Corporation created by license or charter to serve McDonald's purposes.

18. Because McDonald's Corporation does not act in the nature of an intermediary between the restaurants and the

Taxpayer, the intermediary service provision (HRS § 237-13(6)) does not apply to Taxpayer's situation.

- C. The ultimate recipient of the benefits Of Taxpayer's management services is McDonald's Corporation, not the McDonald's restaurants; and therefore no intermediary relationship exists.

19. HRS § 237-13(6) requires that the "ultimate recipient of the benefits of such services" provided by the Taxpayer be some person other than the intermediary. If the ultimate recipient of the benefits of Taxpayer's services is the intermediary, then clearly no intermediary relationship exists.

20. The facts show that the ultimate recipient of the benefits of Taxpayer's services is McDonald's Corporation, not the restaurants. The Management Services Agreement requires Taxpayer to perform two types of services for McDonald's: (a) "general supervisory services with respect to the management of the Restaurants" and (b) "those contractual obligations and duties . . . as may be required pursuant to the terms and provisions of the relevant License Agreements."

21. The general supervisory services were requested by and performed for the benefit of McDonald's Corporation. The restaurants did not request these general supervisory services. McDonald's Corporation has stated that Taxpayer is one of its corporations "which oversee[s] the restaurant operations" and is "responsible for the quality of products."

Letter dated July 28, 1983, Fremgen to Wakumoto, SOF Exhibit 4. Taxpayer is a quality control agent for McDonald's whose purpose is to prevent and correct any deviation by the restaurants from the McDonald's System. Taxpayer protects McDonald's from deviations which may threaten McDonald's trademarks, service marks, valuable good will, wide family acceptance, the McDonald's System, and ultimately, McDonald's profitability. Therefore the general supervisory services are performed at the request of and for the benefit of the McDonald's Corporation, rather than for the restaurants.

22. The Taxpayer also performs the second type of service (the contractual obligations required under the License Agreements) for the McDonald's Corporation. The License Agreements require McDonald's to: (a) "advise and consult" with the restaurants and (b) to communicate its know-how and new developments. License Agreement, p. 2, SOF Exhibit 1. McDonald's is bound by contract to perform these obligations. Taxpayer performs McDonald's obligations to the restaurants on behalf of and for the ultimate benefit of McDonald's.

23. In In re Busk Enterprises, Inc., 53 Haw. 518 (1972), the Hawaii Supreme Court held that where a "pre-existing contractual obligation" between customer and service provider is subcontracted to a third party, the recipient of the performance by the third party is the service provider, not the customer, and therefore no intermediary relationship exists. Taxpayer's performance of McDonald's

contractual obligations under the License Agreements is no different.

24. For the reasons above, the ultimate recipient of the benefits of Taxpayer's services is McDonald's Corporation, not the restaurants, and therefore no intermediary relationship exists .

CONCLUSION

The assessments under appeal are therefore valid and legal; and judgment should be entered in favor of the Director for the total amount in dispute.

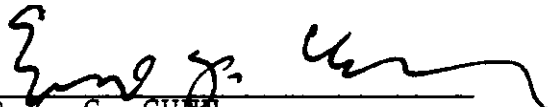
DATED: Honolulu, Hawaii, AUG 8 1985

Edwin H. Honda

JUDGE OF THE ABOVE ENTITLED COURT



APPROVED AS TO FORM:


EDWARD Y. C. CHEN
Attorney for Taxpayer

CASE NO. 2232

IN THE TAX APPEAL COURT OF THE STATE OF HAWAII

IN THE MATTER OF THE TAX)	
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McDONALD'S RESTAURANTS OF)	
HAWAII, INC., as the)	
successor in interest of)	
McDONALD'S OF HAWAII)	
MANAGEMENT CORPORATION)	
_____)	

JUDGMENT

In accordance with the foregoing Findings of Fact and Conclusions of Law;

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the assessments of general excise tax against McDonald's of Hawaii Management Corporation for calendar years 1978, 1979, 1980 and 1981, (which Taxpayer has appealed in part) are valid and legal, and Judgment is entered in favor of the DIRECTOR OF TAXATION OF THE STATE OF HAWAII and against McDonald's Restaurants of Hawaii, Inc. with respect to said assessments.

DATED: Honolulu, Hawaii, AUG 8 1986

Edwin A. Jones

JUDGE OF THE ABOVE-ENTITLED COURT

