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NYS Strikes Again: The Tribunal Addresses Economic Substance

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A recent decision by the New York State Tax Appeals Tribunal offers interesting insights into how the Tribunal is thinking about those slippery concepts known as "economic substance" and business purpose -- at least in the context of intangibles holding companies ("IHC"). Inasmuch as New York has, since 2003, disallowed most deductions for royalties paid to related parties, the IHC structure itself is of mostly historical interest at this point. However, the concepts of economic substance and business purpose have considerable ongoing importance, making this case quite relevant in our current planning environment.

In *Talbots, Inc.*,[1] issued September 8, 2008, the Tribunal recited the history of the apparel company trademarks that were held, since 1993, in an Illinois corporation ("Classics"), and for the five preceding years in a Dutch corporation ("B.V."), and licensed to Talbots. Finding a "complete lack of evidence indicating any purpose whatsoever outside of a tax savings motivation for Classics purchasing the trademarks," and citing *Sherwin Williams*,[2] the Tribunal concluded that "the transaction between Talbots and Classics lacked any economic substance or any valid business purpose [and] the Division properly required petitioner to file on a combined basis with Classics during the years at issue."[3] While it is not possible, absent an appeal, to know what the "voluminous" record actually showed, the thinking expressed by the Tribunal in reaching their conclusion makes some interesting points. The decision also repeats the theory, expressed in *Sherwin Williams* as well, that the consequence of finding that a transaction has no substance is to require the parties to file on a combined basis.

[1] *Matter of Talbots, Inc.*, DTA No. 820168 (N.Y.S. Div. of Tax App. Trib., Sept. 8, 2008), 2008 WL 4294963.

[2] *Matter of Sherwin-Williams Co.*, DTA No. 816712 (N.Y.S. Tax App. Trib., June 5, 2003), *aff'd*, 12 A.D.3d 112 (3d Dep't 2004), *appeal denied*, 4 N.Y.3d 709 (2005).

[3] *Talbot*, at p. 26.

Looking first at what influenced the Tribunal, one thing plainly did not. Talbots, the payor of the royalties, had been audited by the IRS, and audited twice previously by New York State, at a time when it was paying royalties of $9 to $10 million annually to B.V., which of course paid neither state nor federal income tax on that income. The IRS "questioned" the deduction, but ultimately made no adjustment to Talbots' income in respect of the deductions claimed. New York also looked at the deduction, but concluded it could not combine the alien affiliate, B.V., and as a result also made no adjustment. It was not until the trademarks were transferred from B.V. to the Illinois corporation that New York did something to challenge the arrangement. The fact the arrangement had withstood the IRS audit had, however, no observable effect on the Tribunal's analysis. It concluded that the original transfer of the trademarks from Talbots to B.V. was a "well-thought out and aggressive tax avoidance scheme" lacking economic substance and business purpose, a conclusion that, in the federal context would have supported a disallowance of the royalty deduction, but apparently was not reached.

In terms of the specific facts on which the Tribunal premised its legal conclusion, it cited the following: Talbots "was in charge of maintaining and using the trademarks including setting quality standards and developing the Marketing Plan"; B.V. and Classics had only two, part-time employees, neither of whom leapt off the page as trademark specialists; neither IHC owned any property, and B.V. had shared office space while Classics had a sublease of 200 square feet; Classics never performed any quality control work, never performed any product manufacturing or distribution, did not perform any store development, catalog creation or mailings, did not sell any branded products, and did not pay for any advertising; and Classics did not have any employee that was not also an employee of Talbots. In short, the Tribunal concluded "the only party that employed the trademarks in this case was Talbots."[4]

When dealing in an environment in which tax planning is perceived as a significant influence over the parties, it may be intellectually easier to conclude that the facts do not bear out the bona fides of an arrangement. However, as with much litigation, it can be difficult to tell from the decision what facts might have been mustered to support a contrary conclusion. The Tribunal here cited none, and said there were none in the record, making the weighing of benefits, burdens, and bona fides rather lopsided.

More broadly, and of greater concern, is the phenomenon that "bad cases make bad law," something witnessed in recent years in the federal realm as a well, where numerous varieties of "tax shelters" have produced many cases that interpret and apply these and other common law doctrines, and may in the end simply boil down to a smell test. One could, for example, contemplate the inactivity of a landlord under a long-term triple net ground lease, and wonder how to distinguish it from Classics, yet on some level we "know" that there are entirely legitimate transactions, even with affiliates, in which one party may have an exceedingly passive role.

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[4] *Id.*

Finally, it is interesting to note the dollar amounts involved in this case. While B.V. was in place, the group enjoyed considerable tax savings owing to the exclusion of the royalty income from the U.S. federal net. Once the trademarks were brought back to Illinois, however, a move made necessary to effect an IPO, the saving were reduced markedly – projected in fact to amount to only $100,000 to $200,000 per annum. Indeed, the New York tax at issue in the three years litigated in *Talbots* was just $168,000, plus a penalty in respect of one year. It is interesting that a transaction involving nominally $103 million in assets and annual royalty payments approximating $12 million would be held to lack all economic substance and business purpose beyond a few hundred thousand dollars in New York savings; obviously the Tribunal was influenced by its perception that the origin of the arrangement, with B.V., involved more significant federal tax planning. Stated differently, while the original tax planning may no longer have had much significance, its taint lived on.

Turning to the second element of interest, while the Tribunal said that a transaction lacking economic substance and business purpose apart from tax avoidance will be "disregarded," the cure actually imposed by *Sherwin Williams* and *Talbots* was, as noted above, to force the corporations to file in New York on a combined basis. Given New York's law as in effect for these years, this remedy implicitly means that the payment of royalties in a circumstance in which the transaction lacks economic substance is, in itself, distortive, even if the royalty rate might otherwise be reasonable in a "real" transaction. Indeed, in *Sherwin Williams* the Appellate Division endorsed the conclusion, expressed now in *Talbots* as well, that the court need not delve into the difficult business of transfer pricing analysis once it is determined that the transaction itself lacks economic substance – a sensible application of judicial economy.

Combination is not, however, a uniformly available remedy. As noted, New York law currently does not permit the combination of "alien" corporations formed outside the United States.[5] Nor is it possible to combine banking corporations filing under Article 32 with corporations properly filing under Article 9-A. Combination in New York requires at least 80% common ownership, something one might be able to plan around in certain circumstances. Combination also requires a finding that the two corporations are engaged in a unitary business. This may well be a relatively easy lift when the recipient of the royalties does nothing besides hold all of the trademarks relating to the core business of the payor. However, it will not uniformly be the case that parties to a suspect transaction are engaged in unitary business operations.

It is therefore interesting that the Department pursues, and the Tribunal has brought into play, the notion that where the problem is that a corporation that has no economic substance – or stated differently that a corporation is a party to an arrangement that lacks economic substance – the solution is to combine the culprits. Alternative remedies include disallowing the payor's deduction as lacking economic substance or reattributing ownership of the income-producing asset to the payee. These approaches can have different consequences. For example, if the payee is not part of

[5] See N.Y.C.R.R., tit. 20, § 6-2.5(b).

the combined group, the assets of the payee would not be available to pay the taxes of the affiliated corporations, something that could present a problem for the State in some cases. On the other hand, one can envision circumstances wherein combination is not as attractive an outcome for the government as simply ignoring the transaction outright.

As combination wanes as a battleground in New York State the kinds of transactions that gave rise to the decisions in *Sherwin Williams* and *Talbots* are becoming less relevant as well. However, the basic concepts that these two cases bring to the fore – that economic substance and business purpose matter, and that the remedy for a lack thereof is combination – will likely only grow in significance with time.

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