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Maryland and Massachusetts Blur the Lines: Business Purpose, Economic Substance and Sham Transactions

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State and local administrative and judicial bodies have increasingly cited a lack of business purpose and/or economic substance to deny the tax benefits of what they classify as tax-motivated, sham transactions. Recently, courts in Maryland and Massachusetts expanded the reach of these amorphous concepts even further. The Maryland Tax Court upheld income tax assessments against two Delaware intangible holding companies that the court deemed to lack economic substance apart from their parent.¹ In like manner, a Massachusetts appeals court upheld the Appellate Tax Board's refusal to abate certain corporate excise taxes assessed against an in-state parent company after concluding that the parent's transfer of its world logo licensing business to a remote subsidiary constituted a sham.²

A Brief History

At its broadest, the issue posed by the "business purpose" and "economic substance" doctrines is whether, and, if so when, the literal language of a statute or regulation should be overridden because it leads to an inappropriate result. Courts have sometimes held that a transaction that fits within the literal language of a statute or regulation will not be respected for tax purposes, even though it may be respected for other purposes, if the transaction lacks a legitimate business purpose other than to achieve a tax objective or if the transaction lacks economic substance. Underlying these notions is the well-accepted principle of statutory construction that a statute's literal language will not be followed when it leads to an absurd result. Certain transactions, particularly intercompany transactions, have become targets for business purpose or economic substance challenges by state taxing authorities.

¹ See *W.L. Gore & Assocs., Inc. v. Md. Comptroller of the Treasury*, Nos. 07-IN-OO-0084, 07-IN-OO-0085, and 07-IN-OO-0086 (Md. Tax Ct. Nov. 9, 2010).

² See *IDC Research, Inc. v. Mass. Comm'r of Rev.*, No. 09-P-1533, 2010 WL 4814689 (Mass. App. Ct. Nov. 30, 2010).

During the 1980s and 1990s, many corporate taxpayers took steps to manage their intellectual properties more effectively by transferring them to a so-called “intangible holding company” or “IHC.” IHCs typically licensed the intellectual properties back to related companies for use in their business in exchange for royalties. Some IHCs loaned the royalty proceeds to the related companies for use in their business, generating interest expense at the related operating company level. In addition to a number of potential non-tax business purposes, the placement of intellectual properties in an IHC generally resulted in state tax savings since the related operating companies deducted the royalties and interest they incurred from their income in the states in which they did business. The IHCs, which typically limited their activities to Delaware, generally qualified for an exemption from the Delaware income tax and were commonly regarded as not being subject to taxation in any other state. States in which the related companies were doing business began challenging the use of IHCs based on a number of theories in the mid to late 1980s.

The South Carolina Supreme Court’s decision in *Geoffrey, Inc. v. South Carolina Tax Commission*³ was one of the first reported decisions involving an IHC. In *Geoffrey*, the court upheld the assessment of South Carolina income taxes against the foreign IHC.⁴ Although the business purpose doctrine was not an issue in *Geoffrey*, the decision paved the way for other states to go after IHCs based on lack of business purpose and other legal theories.

Maryland—Murky Waters

Maryland courts have gradually tangled the business purpose and economic substance doctrines with unitary business and nexus principles to renounce the use of remote IHCs over the last ten years. Specifically, if a remote IHC receiving royalty income from a Maryland affiliate lacks genuine economic substance, Maryland courts have held that the Comptroller may attribute to the IHC the nexus, and where appropriate the apportionment factors, of the Maryland affiliate upon which the IHC supposedly relies for its separate existence.⁵ In *SYL* and *Crown Cork & Seal*, the Maryland Court of Appeals characterized the IHCs as resembling phantom corporations with “a touch of ‘window dressing’ designed to create an illusion of substance.”⁶ The Court of Appeals concluded “[a]lthough officers of the parent corporations may have stated that tax avoidance was not the sole reason for the creation of the subsidiaries, the record demonstrates that sheltering income from state taxation was the predominant reason for the creation of SYL and Crown Delaware.”⁷

³ 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

⁴ *Id.* at 19.

⁵ See *Md. Comptroller of the Treasury v. SYL, Inc. and Crown Cork & Seal Co.*, 825 A.2d 399 (Md. 2003); *The Classics Chicago, Inc. v. Md. Comptroller of the Treasury*, 985 A.2d 593 (Md. Ct. Spec. App. 2010).

⁶ *SYL and Crown Cork & Seal*, 825 A.2d at 415.

⁷ *Id.*

Recently, the Maryland Tax Court reached a similar result as the Court of Appeals in *SYL* and *Crown Cork & Seal*, by employing a slightly different and more troubling analysis.⁸ Petitioners in the matter were two Delaware IHCs wholly-owned by W.L. Gore & Associates (“WL Gore”), a manufacturer with a physical presence in Maryland. WL Gore created the two IHCs to hold and license certain patents and to invest and manage excess funds, respectively. The Maryland comptroller assessed taxes against the IHCs on the basis that neither “has an identity as a separate business entity and that the intangible income [each] receives is directly connected to Maryland activity through the unitary business conducted in Maryland” by WL Gore.⁹

The Tax court stated that “Maryland courts have consistently concluded that the basis of a nexus sufficient to justify taxation is the economic reality of the fact that the parent’s business in Maryland was what produced the income of the subsidiary.”¹⁰ Combining this so-called standard with unitary business principles, the court held that the IHCs “were passive, non-operational entities and did not have a business existence separate and apart from their parent company.”¹¹

In the court’s eye, the facts reflected functional integration, control through stock ownership and common employees, and a reliance by the IHCs on WL Gore’s personnel, office space, and corporate services.¹² The court viewed the evidence as such that substantial nexus existed between the IHCs and Maryland and upheld the assessments against the IHCs.¹³ This case grants the Comptroller alarming authority to apportion a remote entity’s income based upon the apportionment factors of an in-state affiliate and leaves taxpayers guessing as to what exactly constitutes economic substance.

Massachusetts—Clarity Through Codification?

The Massachusetts legislature has codified the “sham transaction doctrine.” The relevant statute provides, “[T]he commissioner may, in his discretion, disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted

⁸ See *W.L. Gore & Assocs., Inc. v. Md. Comptroller of the Treasury*, Nos. 07-IN-OO-0084, 07-IN-OO-0085, and 07-IN-OO-0086 (Md. Tax Ct. Nov. 9, 2010).

⁹ *Id.*

¹⁰ *Id.* (citing *SYL* and *Classics Chicago*).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

tax benefit.”¹⁴ Thus, Massachusetts law requires both a non-tax business purpose and economic substance to pass muster under a sham analysis.

These now statutorily-imposed concepts were previously developed in a series of cases in Massachusetts beginning in 2000.¹⁵ The decisions in *Syms*, *Sherwin-Williams*, and *Cambridge Brands* made clear that the inquiry of whether or not a transaction is a sham “is, of necessity, primarily a factual one, on which the taxpayer bears the burden of proof.”¹⁶ Furthermore, in dealing with situations where remote IHCs are found to lack economic substance, Massachusetts courts have opted to deny the royalty and interest expense deductions taken by the in-state affiliates of such IHCs or to reallocate a portion of the IHCs’ income to their in-state affiliates rather than taxing the remote IHCs directly through puzzling conceptions of nexus like their counterparts in Maryland.¹⁷

On November 30, 2010, a Massachusetts appeals court did just that in upholding the Appellate Tax Board’s finding that a parent company’s transfer of its world logo licensing business to a remote subsidiary “had no economic substance or business purpose other than tax avoidance, and therefore constituted a sham transaction.”¹⁸ International Data Group (“IDG”) is a technology media company based in Massachusetts. IDG Holdings, Inc. (“IDG Holdings”), a subsidiary of IDG, is an IHC based in Delaware. IDG transferred its world logo licensing business to IDG Holdings. In turn, IDG Holdings received royalty income from certain foreign affiliates in exchange for their use of the world log and loaned a portion of this income to IDG periodically. The Appellate Tax Board “concluded that the commissioner properly reallocated royalty income from IDG Holdings to IDG, based on the sham transaction and assignment of income doctrines.”¹⁹

¹⁴ Mass. Gen. Laws ch. 62C, § 3A.

¹⁵ See *Syms Corp. v. Mass. Comm’r of Rev.*, 765 N.E.2d 758 (2002) (disallowing royalty and interest expense deductions based upon the sham transaction doctrine); *The Sherwin-Williams Co. v. Mass. Comm’r of Rev.*, 778 N.E.2d 504 (2002) (concluding that “[b]ecause the record in this case establishes that the reorganization and subsequent transfer and licensing transactions were genuine, creating viable businesses engaged in substantive economic activities apart from the creation of tax benefits for Sherwin-Williams, they cannot be disregarded by the commissioner as a sham regardless of their tax-motivated purpose.”); *Cambridge Brands, Inc. v. Mass. Comm’r of Rev.*, No. C259013 (Mass. App. Tax Bd. July 16, 2003), *aff’d*, 820 N.E.2d 837 (Mass. App. Ct. 2005) (unpublished) (finding that substantial evidence existed to conclude that the arrangement between the various affiliates had a business purpose).

¹⁶ *Syms*, 765 N.E.2d at 764.

¹⁷ See, e.g., *The Talbots, Inc. v. Mass. Comm’r of Rev.*, Nos. C266698, C271840, and C276882, 2009 WL 3162121 (Mass. App. Tax Bd. Sept. 29, 2009) (holding that the Commissioner properly reattributed to Talbots all of the royalty income and interest income earned by investment of the Talbots Marks.)

¹⁸ *IDC Research, Inc. v. Mass. Comm’r of Rev.*, No. 09-P-1533, 2010 WL 4814689, at *1 (Mass. App. Ct. Nov. 30, 2010).

¹⁹ *Id.*

The appeals court agreed, finding “that IDG did not sustain its burden of proving that it was entitled to an abatement of corporate excise taxes on amounts it claimed were earned by IDG Holdings.”²⁰ The court questioned IDG Holdings’ standing as a viable entity for tax purposes, pointing out that its only activities consisted of receiving royalties, automatically investing these amounts when its account reached a certain level, and briefly leasing an office suite at its bank.²¹ Moreover, though the court believed that IDG may not have transferred ownership of the world logo at all, it stated that even if the logo had been transferred, “the transactions still lacked economic substance or effect because IDG retained full use and control of the world logo and the benefits and burdens of its ownership.”²²

The Massachusetts appeals court also accepted the board’s finding that there was no substantive business purpose to transfer the world logo licensing business to IDG Holdings.²³ Even with little or no direct evidence that the transaction was undertaken solely for tax avoidance, the court pointed out that the burden was on IDG to prove a non-tax motive.²⁴ The court concluded that “the control IDG maintained over IDG Holdings bore none of the hands-off features that typified its relationships with its other subsidiaries” and the transfer of the world logo licensing business was not consistent with the company’s claimed goal of decentralization.²⁵

Finally, the Massachusetts court refused to accept IDG’s argument that the sham transaction doctrine did not apply because the licensing of the world logo constituted a new business instead of a reorganization. IDG developed and previously used the world logo and, according to the court, tax “avoidance was amply demonstrated in the record.”²⁶

Conclusion

While it is easy to detect a trend of state tax agencies invoking the business purpose and other doctrines in order to combat perceived state tax planning, identifying trends in how state courts react to such allegations is more difficult. Some state courts have refused to apply the business purpose and related doctrines even when faced with clear evidence of tax motive, leaving it up to the legislature to fix any perceived abuse of the system. Some state courts have searched diligently for the confines of the business purpose doctrine and applied the doctrine against the taxpayer only when compelled by clear evidence. Other state courts, including those in Maryland and Massachusetts,

²⁰ *Id.*

²¹ *Id.* at *1-2.

²² *Id.* at *2.

²³ *Id.* at *4.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.* at *5.

have arguably paid lip service to the legitimate business purpose doctrine as a basis for ruling against the taxpayer when the court felt the taxpayer was engaged in some form of tax planning.

One clear trend is that legislatures are taking a more active role in combating perceived abuse of tax systems. The U.S. Congress recently enacted a federal definition of the “economic substance doctrine.” The Health Care and Education Reconciliation Act was signed into law on March, 30, 2010, and added new code section 7701(o), which states, “In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (a) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position; *and* (b) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”²⁷

It remains to be seen whether similar state legislative attempts to codify common law doctrines such as the business purpose doctrine or attempts to disallow deductions for intercorporate payments will lead to more or less litigation. Given the current economic landscape, it seems unlikely such attempts will thwart the efforts of taxpayers to find even more creative ways of reducing state taxes. Taxpayers should take care to structure transactions that have economic substance and are at least partially motivated by a viable non-tax purpose.



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²⁷ I.R.C. § 7701(o) (emphasis added).