state tax notes™

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Taxing the Invisible: Applying State Tax Concepts To Nonoperating Entities

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In this article, Reed writes about the difficulties in determining how best to apply state corporate tax laws to nonoperating entities since state statutes are not generally drafted with these entities in mind.

State corporate income tax laws generally assume that taxpayers are operating entities with a physical location and employees somewhere. For example, the apportionment formula under the Uniform Division of Income for Tax Purposes Act, with its property, payroll, and receipts factors, contemplates an operating entity. However, nonoperating entities are frequently formed that lack employees or an office. These entities may handle important yet specific or limited objectives. Determining how best to apply state corporate income tax laws to nonoperating entities can be difficult since state tax statutes are not generally drafted with them in mind, and there may be a dearth of administrative guidance addressing how they should be taxed. This article discusses the difficult issues that can arise in applying state corporate income tax concepts to nonoperating entities.

Applying State Jurisdictional Concepts To Nonoperating Entities

Where should nonoperating entities without their own customers be subject to state tax? One might reasonably conclude nowhere. Nonoperating entities without their own customers would not seem to implicate state doing-business statutes that impose corporate income tax on corporations with employees or property in the state or that direct economic activity at the state.

Regardless, and not surprisingly, state revenue departments are asserting jurisdiction over nonoperating entities. Two approaches are common: (1) control; and (2) agency. The first approach entails determining the state in which nonoperating entities are controlled. Under this approach, nonoperating entities are taxed in a state if their principal place of business is in the state[1] or if the individuals who oversee their operations are located[2] in the state.

This approach is relatively taxpayer-friendly and ordinarily would result in nonoperating entities being subject to tax in at most a handful of states.[3] Given the limited activity engaged in by nonoperating entities, restricting state tax jurisdiction to a few states is reasonable.

However, not all state tax administrators apply such a taxpayer-friendly test. Increasingly, state tax administrators are applying a much broader agency test, which takes into account relationships between nonoperating entities and operating in-state entities. The comptroller of Maryland, for example, has been applying an agencylike test to assert that intangible holding companies are doing business in Maryland if they are dependent on related operating entities that conduct business in Maryland.[4]

Similarly, the California Franchise Tax Board has been applying an agency test to assert jurisdiction over bankruptcy remote securitization entities that generally have no offices, agents, employees, or property other than the assets

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[1]For an analogue, see IRC section 7482(b)(1)(B). *See also Hertz Corp. v. Friend*, 559 U.S. 77, 92-93 (2010) (defining a corporation's principal place of business as "the place where a corporation's officers direct, control, and coordinate the corporation's activities").

[2]This type of test was used in *Goldome*, a New York administrative law judge determination. *Matter of the Petition of Goldome Capital Investments, Inc.*, NY DTA No. 807477 (ALJ 1991). Addressing a nonoperating entity that by design was engaged in only minimal business activity, the ALJ determined that it was subject to tax in the state where it is controlled (that is, where its officers who made its decisions were located). *See also Noga Holding (USA) Inc.*, TSB-A-81(12)C (Mar. 5, 1981) (stating that "[i]ndicative of its doing business is the fact that one of Petitioner's two officers is located in New York, that it is in New York that Petitioner keeps its books and records and that such matters as the preparation of tax returns, administrative matters and corporate documentation are handled in New York.").

[3]The state of control and perhaps also the state of incorporation.

[4]*See, e.g.*, *Gore Enterprise Holdings v. Comptroller*, 437 Md. 492 (Md. 2014); *The Classics Chicago Inc. v. Maryland Comptroller of the Treasury*, 189 Md. App. 593 (Md. 2010); *Comptroller of the Treasury v. SYL Inc.*, 375 Md. 78 (Md. 2003); *ConAgra Brands Inc. v. Comptroller*, No. 09-IN-OO-0150 (Md. Tax Ct. 2015); *Staples Inc. v. Comptroller of the Treasury*, 09-IN-OO-0148 (Md. Tax Ct. 2015).

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they securitize and certificates or notes that are sold to investors. This position recently withstood challenge before a California Court of Appeal.[5]

Widespread use of an agency test to assert jurisdiction over nonoperating entities could produce paradoxical results — companies not engaged in activity anywhere could be subject to state tax everywhere. This result flows naturally, since nonoperating entities by their very nature are dependent on related party agents; if they are taxed everywhere related party agents have nexus they could be taxed everywhere. This result seems unreasonable given the limited scope of their activity.

> **State tax administrators are applying a much broader agency test, which takes into account relationships between nonoperating entities and operating in-state entities.**

Application of an agency test to tax nonoperating entities is also constitutionally questionable. Recent U.S. Supreme Court decisions outside the tax area have concluded that a litigant must specifically target the jurisdiction in order for the litigant to have due process clause contacts with the jurisdiction. Moreover, it is not sufficient for a related entity to have a presence in the jurisdiction. For example, in *Goodyear*[6] and *Daimler*,[7] the Court concluded that foreign subsidiaries did not have sufficient contacts with the United States to satisfy due process merely because a related entity operated in the United States. Applying this same logic in the state tax context would lead to the conclusion that nonoperating entities do not have due process clause nexus with a state merely because there are related entities operating in the state. Accordingly, recent Supreme Court case law suggests a way of resisting assertions of jurisdiction over nonoperating entities.[8]

Applying the Unitary Business Concept To Nonoperating Entities

Should nonoperating entities be included in state combined returns? Are they necessarily unitary with operating companies? Nonoperating entities cannot ordinarily be included in a combined return unless they are unitary with members of the combined return. Ultimately, the question therefore becomes whether nonoperating entities are unitary with related operating companies.

This may be a harder question than it might first appear. Instinctively, one might reason that if nonoperating entities have no separate business of their own, they must be contributing to the business of related operating companies, and therefore are unitary. If, however, nonoperating entities are not doing anything other than passively holding investment assets or other intangible property, perhaps they are not contributing to any unitary business. To use a baseball analogy, nonoperating entities may be like bench players. It is clear they are on the same team as the players on the field, but if they are not doing anything, their contribution to the team (group) can fairly be questioned.

Perhaps because that question is difficult, not every state has issued guidance addressing whether nonoperating entities are to be treated as unitary with related operating companies. A few states have addressed the question in the context of holding companies. For example, several states have issued regulations concluding that holding companies are unitary with related operating companies.[9] One rationale for treating holding companies as unitary is set forth in an FTB ruling. As described in the ruling, a holding company's "primary function is as a conduit between the shareholders and the single unitary business that the shareholders indirectly own"; therefore, a holding company is part of a "unitary system" such that it must be considered unitary with other entities that are part of the unitary system.[10]

While most states treat holding companies as unitary, in some states there is no authority, or the answer may be fact-specific.[11] In New York, as one recent decision incisively put it, "A holding company is not necessarily unitary with the corporation it owns."[12] Based on pre-corporate tax reform regulations and case law in New York, a pure holding company is non-unitary if its activity is limited to receiving dividends from the stock of subsidiaries.[13] However, assisting subsidiaries in obtaining outside financing or performing activities for related entities might be enough to make a holding company unitary,[14] again depending on the facts.

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[5] *Harley-Davidson Inc. v. Franchise Tax Board*, No. D064241, Fourth Appellate District (May 28, 2015).

[6] *Goodyear Dunlop Tires Operations S.A. v. Brown*, 564 U.S. __ (2011).

[7] *Daimler AG v. Bauman*, 571 U.S. ___ (2014).

[8] Such an argument is obviously not bulletproof. In *Harley-Davidson*, No. D064241, Fourth Appellate District (May 28, 2015), a California Court of Appeal determined that reliance on recent U.S. Supreme Court case law was unpersuasive.

[9] *See, e.g.*, D.C. Mun. Regs. 159.2 (stating that a "passive parent holding company that directly or indirectly controls one or more operating company subsidiaries engaged in a unitary business shall be deemed to be engaged in a unitary business with the subsidiary or subsidiaries, even if the holding company's activities are primarily passive"); Wis. Admin. Code Tax 2.62(7); Mass. Regs. 830 CMR 63.32B.2(3)(d).

[10] California Legal Ruling 95-7 (Nov. 29, 1995).

[11] *See also Shaklee Corp v. Illinois Dep't of Revenue*, 738 N.E.2d (Ill. App. Ct. 1998); and Arizona DOR Hearing Office Decision 200600035-C (Sept. 15, 2006).

[12] *In the Matter of the Petitions of Sungard Capital Corp.*, Nos. 823631, 823632, 823680, 824167, 824256 (May 19, 2015).

[13] 20 NYCRR 6-2.3(e)(3), Example 2.

[14] *Autotote Ltd.*, TSB-D-90(4)C (Apr. 12, 1990).

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Generally, assuming nonoperating entities have net income, it is preferable for them to be excluded from combined returns.[15] This may not be possible in some states because of explicit regulations or guidance. However, in other states there may be a position depending on facts and the states' case law.

Applying Apportionment Concepts To Nonoperating Entities

Assuming a nonoperating entity is subject to state tax, either because it is doing business in the state or is a member of a combined return, there still exists the thorny matter of determining how its income should be apportioned.

An illustrative example of the difficult apportionment questions that can arise is presented by the recent *First Marblehead* case in Massachusetts.[16] There, a nonoperating holding company held interests in trusts that directly or indirectly securitized loans. The holding company had no other material assets, no payroll or tangible assets, and did not own or lease office space. It was subject to tax in Massachusetts because that is where it was commercially domiciled and where its books and records were held.

An initial issue was whether the holding company should be subject to the regular Massachusetts apportionment rules or the special apportionment rules for financial institutions. Those rules apply to banks and to companies that compete with banks and that derive more than 50 percent of their income from lending.[17]

At first blush, it would seem that the financial institution apportionment rules should not apply to the holding company. After all, it is not a bank and it did not engage in any lending activity. Its sole activity was to hold trusts, and those trusts did not make loans or engage in lending activity, but rather securitized loans. Thus, it was not apparent that the holding company qualified as a financial institution. Nevertheless, the Massachusetts Appellate Tax Board ruled that the holding company was a financial institution. Its reasoning was that (1) makers of loans and purchasers of loans are both "engaged in lending activities"; (2) the trusts therefore are engaged in lending activities by virtue of purchasing loan portfolios; and (3) the activities of the trusts, which are partnerships, flow through to the holding company, and the holding company is therefore engaging in lending activities such that it qualified as a financial institution.[18] That issue was not appealed.

On appeal, the sole issue in dispute was how to source loans for purposes of the holding company's property factor. A financial institution's loans are sourced to the regular place of business with which it has "a preponderance of substantive contacts," according to where the solicitation, investigation, negotiation, approval, and administration (SINAA) occurs.[19] When a loan is assigned to a location that is not a regular place of business, it is presumed, subject to rebuttal by the taxpayer, that the loan was made at the taxpayer's commercial domicile.[20] In *First Marblehead*, the nonoperating holding company had no regular place of business — it lacked an office anywhere. In the absence of an office for the holding company, the taxpayer argued that the relevant offices were the offices of the loan servicers, all of which were outside Massachusetts, so the holding company should have a 0 percent property factor. However, the Massachusetts Department of Revenue successfully argued that the loan servicers' offices were not the taxpayer's regular place of business, and that because the taxpayer had no regular place of business, the loans should be sourced to the taxpayer's commercial domicile (Massachusetts), giving it a 100 percent Massachusetts property factor.[21]

> **While most states treat holding companies as unitary, in some states there is no authority, or the answer may be fact-specific.**

While this was a bad result for the taxpayer litigating the case, other taxpayers could benefit. *First Marblehead* supports a position that holding companies owning special purpose securitization entities are engaged in a lending business and therefore subject to financial institution apportionment rules. It also supports a position that those loans should be sourced to the taxpayer's commercial domicile, a result that is helpful for similarly situated taxpayers commercially domiciled outside Massachusetts. More broadly, the decision's logic could apply in states besides Massachusetts that have similarly adopted apportionment rules for

[15]This is not always the case. For example, if a profitable holding company is included in a combined return, there could still be a net tax savings, such as if the inclusion of the holding company causes loss companies that would not otherwise be included in the combined return to be included.

[16]*First Marblehead Corp. v. Mass. Commissioner of Revenue*, 470 Mass. 497 (Mass. 2015), U.S. Supreme Court petition for writ of certiorari pending. The years at issue are 2004-2006, years before Massachusetts adopted combined reporting.

[17]Mass. Gen. laws ch. 63, section 1. This standard is based on the Multistate Tax Commission Financial Apportionment rules.

[18]*First Marblehead Corp. Gate Holdings Inc. v. Mass. Commissioner of Revenue*, Nos. C293487, C305217, C305240, and C305241 (App. Tax Bd. 2013).

[19]Mass. Gen. laws ch. 63 section 2A(e)(vi)(A)(2).

[20]Mass. Gen. laws ch. 63 section 2A(e)(vi)(A)(3)(B).

[21]It had no payroll factor, and its overall Massachusetts apportionment percentage was 51 percent, taking into account its receipts factor and its 100 percent property factor.

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financial institutions modeled on the Multistate Tax Commission's "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions."[22]

Even more broadly, *First Marblehead* illustrates the sort of difficulties, unclear questions, and all-or-nothing results that can arise when trying to apply apportionment concepts to nonoperating entities.

Conclusion

Nonoperating entities are increasingly being formed to handle significant, but limited, objectives. They may have no employees, no real or tangible property, no offices, and no customers of their own. They may merely hold the stock of subsidiaries, or may hold investment assets or other intangibles. Despite the limited nature of their activities, they can have significant income and receipts. Care should be given to determining where they are subject to tax, whether they must be included in combined returns, and how their apportionment should be computed. Given the inconsistent treatment of nonoperating entities across the states, answers may vary from state to state. ✰

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[22]MTC (Nov. 17, 1994).

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