

State & Local Tax **Alert**

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Vermont Adopts “Economic Substance” Doctrine to Tax Banks

The Vermont Supreme Court has upheld the imposition of tax on three banks, despite the banks’ creation and use of holding companies in an attempt to technically eliminate liability under the Vermont bank franchise tax. In doing so, the court specifically adopted the “economic substance” doctrine, and ruled the holding companies created by the banks were essentially empty shells and not engaged in substantial independent business activity beyond the achievement of tax avoidance.¹

Background

Vermont imposes a bank franchise tax (“BFT”) on banks and financial corporations doing business in the state.² During the years involved, 2000 and 2001, the annual tax was determined by multiplying taxpayers’ average monthly deposits by 0.000096.³ It was capped, however, by an amount based on the federal income tax paid by the banks.⁴ Taxpayers were required to pay the BFT quarterly on a contemporaneous basis, and later reconcile the amount paid with the amount of their final federal tax paid when their federal returns were ultimately filed.⁵ The banks then filed claims for refund of any overpaid taxes.

The taxpayer in this suit, TD Banknorth, was the parent of three subsidiary banks subject to Vermont tax (“banks”), and paid the BFT on their behalf. The banks had each created a subsidiary holding company. Each bank funded its subsidiary with a combination of consumer and real estate loans, asset-backed securities, collateralized mortgages, bonds, tax-exempt municipal bonds and restricted stock. Funding was accomplished through participation agreements, which unlike outright assignments, transferred 100% of the economic interest to the holding companies but retained full risk and management responsibilities in the parent bank. The loans continued to be serviced by TB Banknorth in its headquarters under an arm’s length agreement at industry-standard rates. The holding companies maintained suretyship and pledge agreements for some of the loans with the Federal Home Loan Bank of Boston.

Release date

October 6, 2008

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¹ *TD Banknorth, NA v. Dept. of Taxes*, 2008 Vt. 120, Dkt. No. 2007-127 (September 19, 2008).

² VT. STAT. ANN. tit. 32, § 5836.

³ VT. STAT. ANN. tit. 32, § 5836(b).

⁴ VT. STAT. ANN. tit. 32, § 5836(e) (repealed 2004).

⁵ VT. STAT. ANN. tit. 32, § 5836(c).

The holding companies were properly incorporated in Vermont, with requisite stock, bylaws and other corporate formalities. However, they had no independent office space, real or tangible assets, or employees. It was admitted by TD Banknorth executives at trial that the holding companies were created to take advantage of favorable state tax treatment afforded at that time to holding companies.⁶ Specifically, corporations:

...whose activities are confined to the maintenance and management of their intangible investments and the collection and distribution of the income from such investments...shall [be taxed in an amount] not [to] exceed the \$150.00 minimum tax.⁷

Since the income stream from these assets was no longer reportable to the banks, they posted losses for federal income tax purposes. Therefore, the cap on the BFT was effectively zero. As a result, the banks had no Vermont BFT liability, and the holding companies only paid \$150 each.

The banks, through their parent, claimed and received approximately \$3.5 million BFT refunds. The Vermont Commissioner of Taxes (“Commissioner”) subsequently assessed taxes, interest and underpayment and fraud penalties against TD Banknorth, claiming that the holding companies had “no economic substance or legitimate business purpose and were formed merely to evade the [BFT].”⁸ A Vermont superior court affirmed the Commissioner, and TD Banknorth appealed to the Vermont Supreme Court.

Court Decision

TD Banknorth challenged the Commissioner’s conclusion that the holding companies lacked sufficient business purpose and economic substance to be considered as taxable entities separate from their parent banks.⁹ In substance, taxpayer argued that the holding companies had followed the letter of the law and had sufficient business activity to be respected as distinct taxpayers. The Court disagreed.

In affirming the superior court, the Supreme Court discussed the “economic substance doctrine.” The doctrines of “economic substance” and “business purpose” are often lumped together, commingling the concepts and distorting the proper analysis and application of each doctrine. Economic substance addresses whether a given transaction created a non-tax monetary benefit for the taxpayer (i.e., reducing the cost of doing business). Business purpose addresses whether there exists any non-tax business reason for the transaction (such as liability protection, managerial efficiencies, or regulatory

⁶ TD Banknorth’s tax advisors had called establishing the holding companies a “slam dunk strategy.”

⁷ VT. STAT. ANN. tit. 32, § 5837, repealed by 2003, No. 152 (Adj. Sess.), § 8.

⁸ The Commissioner noticed a “precipitous drop” in the BFT revenues, and initiated an audit of TD Banknorth in 2004 as a result.

⁹ TD Banknorth also argued, and lost, issues concerning statute of limitations and penalty limitations, which are not germane to this Alert.

compliance).¹⁰ The Court decided to lump them both together and refer to them as the economic substance doctrine. After discussion of the doctrine,¹¹ the Court stated unequivocally, “We here adopt the economic substance doctrine in Vermont.”

Applying the doctrine to DT Banknorth’s fact pattern, the Court pointed to several factors leading to its decision. First, the taxpayer’s motivation was purely tax savings. Second, the holding companies failed to conduct sufficient independent business activities. Third, they carried no economic risk. Finally, the Court concluded that:

“Although the holding companies met the literal requirements of [the statute], they will be disregarded under the economic substance doctrine....

...it is absurd to conclude that the Legislature intended [the statute] as a means through which taxpayers could almost completely avoid payment of the bank franchise tax by the creation of shell corporations that have no economic substance and whose sole purpose is to minimize state taxes.”

Commentary

The Vermont Supreme Court issued a forceful decision in adopting the economic purpose doctrine and applying it against the taxpayer’s fact pattern. Although there is sound logic behind the Court’s decision, questions arise concerning whether it may have gone too far in denying a taxpayer’s right to conduct its business as it wishes. Could proper structuring of the holding companies, for example their use of any office, ownership and use of real and tangible personal property, hiring of employees and engaging in transactions with third parties, have resulted in a different decision? Corporations and their tax advisors should undertake an in-depth study of this case to ensure their tax planning will be respected. They should also be vigilant in determining whether other states will adopt similar viewpoints.

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¹⁰ For example, see Giles Sutton and Jamie C. Yesnowitz, “Sophistication of State Tax Laws, Limits of Litigation To Resolve Complex Issues Leave Taxpayers in Quandary,” 2006 BNA Weekly State Tax Report 5, August 11, 2006, which discusses the distinctions between business purpose and economic substance considerations in the state corporate income tax.

¹¹ Citing, among other cases, *Gregory v. Helvering*, 293 U.S. 465 (1935), *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), *Baisch v. Dept. of Revenue*, 850 P.2d 1109 (Or. 1993) and *Sherwin-Williams Co. v. Commissioner*, 778 N.E.2d 504 (Mass. 2002).

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