Fact or *Fiction:*

by William G. Fendley IV

Legitimate Tax Savings Through Delaware IP Holding Companies?

. . . a corporation that simply manages and collects income on its IP will be exempt from Delaware income tax.

A growing number of corporations are achieving substantial state income tax savings by centralizing and managing valuable corporate intellectual property (IP) in intellectual property holding companies (IPHCs) organized in tax-favored states such as Delaware.[1] It should come as no surprise that several states have challenged the propriety of the tax savings purportedly produced by IPHCs. In light of certain successful state attacks, some practitioners have begun to reevaluate the tax efficacy of the IPHC technique. This article highlights certain provisions of Delaware's corporate income tax statute (specifically its exemption applicable to IPHCs); summarizes the "plain vanilla" IPHC structure; briefly outlines and analyzes two of the more popular state attacks and concludes that, absent contrary guidance from the U.S. Supreme Court, the tax savings produced via a properly operating IPHC should be recognized as a legitimate byproduct of prudent corporate structuring.

Delaware Statute

Delaware, like most states, imposes a corporate tax on income related to business activities carried on or property located within its borders during the year. On the other hand, corporations "whose activities within [Delaware] are confined to the maintenance and management of their intangible investments . . . and the collection and distribution of income from such investments" are exempt from Delaware's corporate income tax.[2] For purposes of this exemption, "intangible investments" consist of "stocks, bonds, notes . . . patents, patent applications, trademarks, trade names" and any similar type of intangible property.[3] Thus, a corporation that simply manages and collects income on its IP will be exempt from Delaware income tax. This exemption is the foundation for the tax benefits contemplated by plain vanilla IPHC structure.

Plain Vanilla IPHC Structure[4]

Corporation X (X) typically generates approximately $10 million in annual sales revenue and pays state income tax at 6 percent. X owns valuable IP (e.g., a trade name and related logo) that it uses in its operations. X consults with Advisor A (AA) who advises X that it could greatly improve its ability to manage and protect its IP by transferring it to an IPHC. AA also mentions that in addition to improving its ability to manage and protect its IP, X could produce a large state income tax savings by organizing the IPHC in a state that does not tax holding company income. Following AA's advice, X incorporates[5] Entity H (H) in Delaware and transfers all of its IP to H in exchange for H stock.[6] Thereafter, X enters into a license agreement with H pursuant to which X agrees to pay a reasonable royalty (for the sake of illustration, say 15 percent of sales) to H in return for X's use of H's IP.[7] For state income tax purposes, X anticipates a deduction equal to the entire royalty paid to H, which, if respected, will produce a state income tax savings of ninety thousand dollars.[8] Thereafter, H will eventually (but not immediately) either distribute its royalty income to X as a tax free dividend[9] or it will loan the amounts to X pursuant to a loan agreement providing for interest at a market rate. To the extent that X pays interest to H, X would be entitled to an interest deduction to further reduce its state income tax burden.

Certain State Attacks on IPHCs

For obvious reasons, not the least being the substantial budget shortfalls that have become commonplace in recent years, states have employed a variety of techniques designed to reclaim tax dollars siphoned out of state through the use of IPHCs. Two popular methods of attack are "economic nexus" income taxation and application of the "sham transaction doctrine."

Economic Nexus Taxation In Light of or In Spite of *Quill*?[10]

Rightly or wrongly, several states have attacked nonresident IPHCs by asserting income tax jurisdiction. These states attack IPHCs by simply taxing them, despite the fact that IPHCs routinely have no connection with a taxing state. The extent to which the IPHC structure legitimately produces state income tax savings in these states will ultimately depend on the resolution of the debate over the proper scope of the U.S. Supreme Court's decision rendered in *Quill Corporation v. North Dakota*.[11]

In *Quill,* the Supreme Court confirmed that states may not subject nonresident corporations to tax unless the nexus requirements of both the Due Process Clause and the Commerce Clause of the U.S. Constitution have been satisfied.[12] Moreover, the Court held that while Due Process Clause nexus exists wherever a nonresident corporation avails itself of the benefits of an economic market in the taxing state (regardless of physical presence),[13] Commerce Clause nexus requires a non-*de minimus* degree of physical presence in the taxing state.[14] Many interpret *Quill* as mandating a physical connection with the taxing state with respect to all taxes. Many others, however, maintain that *Quill* is confined solely to sales and use tax matters.

South Carolina was among the first states to contend that *Quill's* physical presence requirement is confined to sales and use taxation. In *Geoffrey, Inc. v. South Carolina Tax Commission*,[15] the Supreme Court of South Carolina affirmed the South Carolina Tax Commission's imposition of South Carolina's corporate income tax on a nonresident (Delaware) IPHC whose only in-state connection consisted of licensing certain trademarks, trade names and merchandising techniques to its parent corporation (Toys R Us) for use in South Carolina. The Court concluded that the IPHC's purposeful direction of activities to South Carolina was sufficient to meet Due Process nexus, while the in-state presence of the IPHC's intellectual property was sufficient to establish Commerce Clause nexus.[16] The *Geoffrey* court rejected the notion that *Quill's* physical presence requirement applies where income taxes are at issue. In reconciling *Quill* with its holding, the *Geoffrey* court stated, "[t]he U.S. Supreme Court recently revisited the physical presence requirement of *Bellas Hess* and . . . noted that the physical presence requirement had *not been extended* to other types of taxes."[17] While *Geoffrey* correctly addressed Due Process nexus, its Commerce Clause nexus analysis is questionable.

The problem with *Geoffrey's* holding regarding the Commerce Clause nexus is that it appears to rest solely on an improper conclusive inference drawn from the U.S. Supreme Court's discussion in *Quill*. With the exception of *Quill*, none of the authorities offered by the *Geoffrey* court can be construed as being technically germane to issue of Commerce Clause nexus. Consequently, whether any substantive value can be attributed to *Geoffrey's* Commerce Clause nexus holding depends on whether *Quill* can be construed as conclusive support. Although the U.S. Supreme Court confirmed in *Quill* that in reviewing other taxes it had not yet "*articulated* [or formally adopted[18]] the same physical presence requirement that *Bellas Hess* established for sales and use taxes . . . [,]"[19] the Court's silence *alone*, regarding other taxes, cannot be interpreted as giving rise to a conclusive inference that the physical presence requirement does not extend to other areas of taxation. This is true where other areas of taxation do not differ substantially from those at issue in *Quill* and *Bellas Hess* (i.e., sales and use taxes).[20] Income taxes do not differ enough from sales or use taxes to necessitate or support a differing degree of Commerce Clause nexus.

Substantive shortcomings aside, the U.S. Supreme Court declined to review *Geoffrey*,[21] and, despite no legal significance attributable to a denial of *certiorari*, its theory of nexus, commonly referred to as "economic nexus,"[22] has since been adopted by several state tax authorities.[23] Notwithstanding the activities of such tax authorities, however, and perhaps indicative of its shortcomings, *Geoffrey* has not been widely followed by courts. As recently as October 23, 2003, *Geoffrey* was criticized by the Tax Court of New Jersey.[24]

In *Lanco Inc. v Director, Division of Taxation,* a case with facts virtually identical to *Geoffrey*, the Tax Court of New Jersey confirmed that notwithstanding a New Jersey economic nexus regulation permitting the taxation of nonresident IPHCs, physical presence is a prerequisite to Commerce Clause nexus and that Commerce Clause nexus, in turn, remains a prerequisite to a state's ability to assert income tax jurisdiction over a nonresident IPHC.[25] In rejecting *Geoffrey*, the *Lanco* court explained that income taxes are not so different from sales and use taxes to require a different degree of Commerce Clause nexus; the U.S. Supreme Court cases decided prior to *Quill* strongly suggest a physical presence element of nexus; and state courts have not relied upon *Geoffrey*.[26]

Although the U.S. Supreme Court will ultimately step in to formally resolve the debate over whether *Quill's* physical presence requirement applies to income taxes, until then *Lanco* appears to be the better view. Regardless of whether *Geoffrey* or *Lanco* represents the better view, however, the risk of economic nexus income taxation is not the only potential obstacle faced by IPHCs.

Disregarding IPHCs Under the Sham Transaction Doctrine

Federal tax law has long recognized that where a transaction has no business purpose other than tax savings (i.e., where a transaction lacks economic substance), the transaction may be disregarded under what has come to be known as the "sham transaction doctrine."[27] Recently, states have argued that the principles of the federal sham transaction doctrine should apply to the IPHC structures and that deductions generated by the transactions between a corporation and an IPHC should be completely ignored as a result.

In *Syms Corp. v. Commissioner of Revenue,*[28] the Supreme Judicial Court of Massachusetts affirmed the state Appellate Tax Board's application of the sham transaction doctrine to disregard transactions occurring between Syms Corp. (Syms) and SYL, its newly- formed IPHC. In affirming the Tax Board, and notwithstanding Syms' listing of nearly a dozen non-tax business purposes for forming SYL, the Court emphasized the following: a variety of Syms' documents indicated that transaction was undertaken simply to generate tax savings; Syms continued to pay all expenses related to the maintenance, management and defense of the IP, despite the fact that SYL was technically the owner of the IP; SYL had no income other than royalty income from Syms; SYL waited only a few weeks before returning royalty payments to Syms, as dividends; and SYL's expenses represented only a nominal percentage of its total income. Based on the foregoing, the Court concluded that the transaction could be completely ignored for having no practical economic effect on Syms, other than the creation of tax benefits.[29]

In *Sherwin-Williams Co. v. Commissioner of Revenue,*[30] the Supreme Judicial Court of Massachusetts, once again, reviewed a sham-based attack on IPHCs. Ohio-based Sherwin-Williams Company (SWC) formed two wholly owned Delaware IPHCs to hold and manage certain IP transferred to them by SWC. Following SWC's transfer, the IPHCs licensed most of the IP back to SWC in exchange for quarterly royalties based on sales revenue. Once organized and operational, the IPHCs also licensed IP to third parties and paid a variety of fees related to the maintenance, management and defense of the IP. Finally, the IPHCs also invested royalty income with third parties and earned better returns than SWC on comparable funds. Although the Appellate Tax Board confirmed the commissioner's conclusion that the transfer of the IP and the license back to SWC was a sham, the Court disagreed. The Court held that, unlike *Syms*, the activities of SWC's IPHCs indicated viable, ongoing business enterprises within the SWC family not "businesses in form only, to be 'put to death' after exercising the limited function of creating a tax benefit," and, as such, regardless of SWC's tax motives, the entities could not be disregarded as shams.

While the sham transaction doctrine is by no means uniformly applied in all areas of federal or state taxation, within the distinctions between *Syms* and *Sherwin-Williams* are certain guidelines for triggering and, more importantly, avoiding the application of the sham transaction doctrine in the IPHC setting. In *Syms*, for example, the Court found the parent corporation's payment of the IPHC's expenses coupled with the circular flow of cash (i.e., the immediate return of royalties by the IPHC) between the parent and the IPHC particularly indicative of a disregardable tax avoidance scheme. On the other hand, in *Sherwin-Williams*, notwithstanding the corporation's tax motives, the Court found the IPHCs ability to retain and invest its royalty income, its payment of its own expenses and its licensing of IP to third parties indicative of an viable, ongoing business. At a minimum, corporations forming IPHCs should avoid similarities with *Syms* but not *Sherwin-Williams*. The corporation forming the IPHC should retain any and all documents (including corporate minutes and resolutions) demonstrating non-tax reasons for creating the IPHC; the corporation should pay royalties more frequently than once a year; the IPHC should not immediately return royalty income to its parent; the IPHC should pay its own expenses, if possible; the IPHC should lease IP to third parties and the IPHC should have the power to invest its income.

In addition to economic nexus and sham-based attacks, it should be noted that states have also challenged the propriety of the tax savings produced by IPHCs under economic distortion principles as well, causing corporations to prove the arm's length nature of transactions taking place between the parent corporation and the IPHC.

Conclusion

Although some are reevaluating the tax efficacy of the IPHC structure, in light of the foregoing, and provided that a nonresident IPHC is organized and operated as a viable business, states should neither disregard nor attempt to assert income tax jurisdiction over the IPHC to eliminate the tax savings.

Endnotes:

1 Given that it has no corporate income tax, IPHCs have also been organized in Nevada.

2 *Del. Code Ann.* § 1902(b)(8).

3 *Id.*

4 The Plain Vanilla Structure contained herein is provided as illustration only. There are a number of structures that should be considered by corporations contemplating the formation of an IPHC.

5 Alternatively, X may form a Delaware LLC that would "check the box" to be treated as a corporation for federal income taxes. See *Del. Code Ann.* § 1901(3) and *Treas. Reg.* § 301.7701-3.

6 This should be tax free pursuant to IRC § 351.

7 By "reasonable," *see IRC* § 482.

8 $1,500,000 x 6% = $90,000.

9 *IRC* § 243.

10 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

11 *Id.*

12 *Id.*

13 *Id.* at 307.

14 *Id.*

15 *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E. 2d. 13 (S.C. 1993).

16 *Id.*

17 *Id.* at 18 (citing *Quill*)(emphasis added).

18 *See Quill* at 317.

19 *Quill* at 314.

20 *See*, e.g., *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. App. 1999).

21 *Geoffrey, Inc. v. S.C. Tax Comm'n*, 510 U.S. 992 (1993)

22 *See* Craig J. Langstraat & Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 Akron Tax J. 1 (1999)

23 For example, Arkansas, Florida, Iowa, Massachusetts, New Jersey, and Wisconsin each adopted *Geoffrey's* interpretation of nexus by specific rule or regulation.

24 *Lanco, Inc. v. Director, Division of Taxation*, Docket 005329-97(Tax Court of New Jersey)(October 23, 2003).

25 *Id.*

26 *Id.*

27 *See*, e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935).

28 765 N.E. 2d. 758 (Mass., 2002).

29 *Id.*

30 778 N.E. 2d 504 (Mass.,2002).

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