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Comments

Pennsylvania's Use of the Sham Transaction Doctrine to Plug the Intangible Holding Company Loophole

Giuseppina M. Galloro*

I. Introduction

"The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[1] This statement by the Supreme Court in *Gregory v. Helvering*[2] is a bedrock principle of tax law and has been the primary motivation for taxpayers for over half a century. But what are the consequences of this tax avoidance?

Using strategies that have evolved over the past twenty years and

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1. Gregory v. Helvering, 293 U.S. 465, 469 (1934).
2. *Id.*

reached their height in the past five to seven years,[3] multistate corporations have taken advantage of loopholes hidden in state corporate income tax statutes to avoid paying taxes on certain types of income.[4] These strategies have caused a significant drop in the amount of revenue earned by the states through corporate income taxes.[5] Many states are facing large budget deficits,[6] and this loss in revenue may be hard for states to swallow, particularly when it seems that the only option available to balance their budgets is to increase taxes or to slash many social programs.[7] States have been forced to develop creative strategies to generate much needed income[8] and have tried to develop ways to plug these revenue-leaking loopholes.

The three most common tax avoidance strategies employed by multistate corporations are: (1) the "nowhere income" loophole in which the corporation will earn profits in a state that does not subject the corporation to tax because the requisite nexus between the state and the corporation has not been established;[9] (2) the shifting of intangible

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3. Glenn R. Simpson, *Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States,* WALL ST. J., August 9, 2002, at A1.

4. Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, (Ctr. on Budget and Policy Priorities, Washington, D.C.), *available at* http://www.cbpp.org/4-9-02sfp.htm (revised May 23, 2003). For example, corporations that take advantage of loopholes to avoid paying taxes on income generated from the lease of intangibles from subsidiary corporations to parent corporations and non-business income. *Id.*

5. Mazerov, *supra* note 4, at 1 (data supplied by U.S. Census Bureau reveals 3.9% decrease in revenue generated by state corporate income tax in the years between 1979 and 2000 from 10.2% to 6.3% of state tax revenue); *see also, 'Tax Sheltering' May Cost States One-Third of Revenue, says MTC*, 2003 TAX DAY, *at* http://tax.cchgroup.com (July 17, 2003) [hereinafter 2003 TAX DAY] (corporate tax sheltering may have reduced state corporate income tax revenue by more than one third in 2001).

6. Tim Reason, *Stingers: The 2004 State Tax Survey,* CFO MAGAZINE, Jan. 2004, *available at* http://www.cfo.com (last modified Jan. 12, 2004).

7. Nicholas Johnson, *Projected State Budget Deficits for Fiscal Year 2005 Continue to Threaten Public Services*, (Ctr. on Budget and Policy Priorities, Washington D.C.) *available at* www.cbpp.org/10-22-03sfp2.htm (last modified Dec. 22, 2003); *see also A Brief Update on State Fiscal Conditions and the Effects of Federal Policies on State Budgets*, (Ctr. on Budget and Policy Priorities, Washington D.C.) *available at* www.cbpp.org/9-13-04sfp.htm (last modified September 13, 2004).

8. *See, e.g.*, Edward Rendell, *State Needs More Funds For School, Jobs; The State Can't Eliminate Its Budget Deficit With Spending Cuts Alone. It Needs to Raise New Revenue to Stabalize its Finances*, LANCASTER NEW ERA, Sept. 9, 2003, at A7 (Pennsylvania's recent attempt to generate income through the addition of slot machines at the states many race tracks). *See also,* Robert Tanner, *Strapped States Raising Taxes, Fees,* PITTSBURGH POST-GAZETTE, June 13, 2003, C13.

9. Before a state can tax any of a corporation's income earned in the state, the federal government requires that the corporation must meet a threshold level of presence, "nexus," with the state. Mazerov, *supra* note 4, at 3-5. The "no-where income" loophole is used in situations where sufficient "nexus" between the corporation and the state cannot be established. *Id.* In this situation, the income generated in the state is not

property to "intangible holding companies" (IHCs); and (3) the defining of income generated from certain types of transaction as "non-business income."[10] The states who have been hardest hit by these practices, collectively referred to as "corporate tax sheltering," are California ($1.34 billion in corporate income tax collection losses), Illinois ($693 million), Texas ($607 million), and Pennsylvania ($582 million).[11]

Figure 1—Share of Total State Taxes Contributed by Corporate Income Tax (1979-2000)[12]

STATE	1979	1989	2000
All States	10.20%	8.80%	6.30%
California	14.50%	12.30%	7.90%
Connecticut	13.50%	16.60%	4.20%
Kansas	11.90%	7.90%	5.60%
Massachusetts	13.40%	13.00%	8.10%
New Hampshire	24.20%	24.80%	18.40%

subject to tax by the state. *Id.* However, because the income is generated within a particular state, the income is not subject to tax by any other state. *Id.* The income becomes "no-where income," which is income earned within a state but is not subject to tax by any state. *Id.* For a more in-depth discussion of the "no-where income" income loophole, *see* Walter Hellerstein, *State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond,* 48 TAX L. REV. 739 (Fall 1993).

10. The Supreme Court has determined that only certain types of income may be allocated. *See* ASARCO, Inc. v. Idaho Tax Comm'n, 458 U.S. 307 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept. of NM, 458 U.S. 354 (1982). Allocable income, referred to as "business income" is defined as income "arising from transactions and activity in the regular course of the taxpayer's trade or business." Mazerov, *supra* note 4, at 7-8. Income which does not meet this definition is classified as "non-business income" and is not subject to tax. *Id.* Corporations taking advantage of the "non-business income" definition characterize transactions as one which does not occur in the regular course of a trade or business. *Id.* Corporations have been extremely successful in many states with this argument and have begun to treat transactions on the borderline of the "business," "non-business" distinction as "non-business" income for which they are not subject to tax. *Id.* For a more in-depth discussion of the "non-business" income loophole *see* Walter Hellerstein, *State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond,* 48 TAX L. REV. 739 (Fall 1993).

11. 2003 TAX DAY, *supra* note 5.

12. Mazerov, *supra* note 4. Figure 1 shows the decline in the percentage contributed by corporate income tax to the total tax of a state. The ten states with the greatest decline are displayed. *Id.*

Ohio	10.90%	6.80%	3.20%
Pennsylvania	12.60%	9.20%	7.60%
South Carolina	9.20%	5.90%	3.60%
Vermont	8.90%	6.00%	3.00%
Wisconsin	10.00%	7.00%	4.60%

This comment will focus on the IHC loophole and the attempts made by different states to close this loophole. Specific attention will be paid to the strategy proposed by the Pennsylvania Legislature to recoup income lost through the creation and use of IHCs and the relative effectiveness of this strategy. Part II discusses the IHC loophole and how corporations subject to Pennsylvania taxes structure their transactions in order to take advantage of the loophole. Part III examines the federally created sham transaction doctrine and the states' use of this doctrine to recoup income lost due to the IHC loophole. Part IV discusses the Pennsylvania Legislature's attempt to close the IHC loophole through the codification of the sham transaction doctrine proposed in House Bill 1305. Part V analyzes the effectiveness of the proposed legislation.

II. IHCs and the Leasing of Intangible Property

Pennsylvania has the highest corporate tax rate in the nation, taxing corporations at a rate of 9.99%.[13] Yet, Pennsylvania is fourth in the nation at estimated losses from corporate tax collections.[14] This loss in revenue is partly attributable to an aggressive tax strategy employed by multistate corporations that conduct business and are taxed in Pennsylvania.[15] The strategy allows corporations to reduce their income for expenses the corporation incurs when it pays for the use of intangible property.[16] There is some discrepancy as to the exact amount of revenue

13. Johanna A. Pro, *Rendell, Business at Odds on Tax Loophole*, PITTSBURGH POST-GAZETTE, July 27, 2003, at E1.

14. 2003 TAX DAY, *supra* note 5.

15. Testimony of Renee Blocker, Multistate Tax Commission, before the Pennsylvania Business Tax Reform Commission, Afternoon Session, May 17, 2004, p.213, 238 [on file with author]; *see also,* Beth McConnell, *The Great Escape: How Major Corporations Avoid State Taxes*, (PennPIRG and the PennPIRG Educ. Fund, Philadelphia, Pa.), July 2003, at 3.

16. Mazerov, *supra* note 4, at 5.

Pennsylvania could raise by closing this loophole. The Rendell Administration estimates that $100 million in revenue from state taxes could be raised by closing this tax loophole.[17] In contrast, the Pennsylvania Chamber of Commerce, in testimony before the Pennsylvania House Finance Committee,[18] estimates the increase in state revenues recouped from closing the IHC loophole to be in the range of one to two billion dollars.[19] Although it is likely that neither estimate is wholly accurate,[20] Pennsylvania clearly stands to raise a significant amount of revenue if the General Assembly can develop a strategy to close the IHC loophole found in the state's corporate tax statutes. Closing the IHC loophole would be an achievement of great significance given Pennsylvania's recent budget crisis.

A. Effect of the IHC Structure on Federal Taxes

It is important to have a general understanding of how corporations structure both the relationship between the parent company and its IHC subsidiary, and the transaction between the two companies to fully understand the resultant tax consequences of the IHC loophole and what measures Pennsylvania can take to plug this loophole. This transaction has different tax consequences at the federal and state levels, but it is the combined savings in both arenas that makes the IHC such a viable and lucrative tax strategy.[21]

A recent example, involving WorldCom, Inc. (WorldCom), illustrates the effect a corporation's use of the IHC loophole has on its taxable income.[22] After WorldCom filed for bankruptcy protection in July 2002,[23] documents admitted in the bankruptcy proceedings revealed that the corporation may have avoided hundreds of millions of dollars in state taxes by passing almost $19 million in revenue through a Delaware intangible holding company.[24] Pursuant to the advice of the accounting firm of KPMG, LLP,[25] WorldCom transferred the rights to its trademarks

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17. Pro, *supra* note 13.

18. *Hearing on HB 1305 Before the House Finanace Committee*, 2003 Leg., (Pa. 2003) (written testimony of Jim Welty, Vice President, Legislative and Corporate Affairs of the Pennsylvania Chamber of Business and Industry).

19. McConnell, *supra* note 15 at 5.

20. *Id.* at 6. PennPIRG, analyzing the revenues generated by states who had successfully closed the IHC loophole, puts the estimate at closer to $296 million.

21. *Id.* at 7.

22. Carrick Mollenkamp et al., *WorldCom Tax Strategy May Have Helped it Save Millions*, WALL ST. J., Aug. 14, 2003, at C1.

23. *Id.*

24. *Id.* at C1. In Mollenkamp's article the Delaware IHC is referred to as a "passive investment company."

25. KPMG, LLP, U.S. member firm of KPMG International, a Swiss Cooperative.

to the Delaware IHC, which then leased use of the trademark back to WorldCom's parent company and other subsidiaries.[26] This transaction allowed WorldCom to deduct the royalties paid to the Delaware IHC[27] as an expense while at the same time generating untaxed income for the Delaware IHC.[28]

Why is this type of transaction problematic for Pennsylvania tax purposes? The issue arises when companies engaged in these transactions file a federal consolidated income tax return. For illustration purposes, let us consider a hypothetical corporation under the name PMG, Inc. (PMG). PMG is located in Pennsylvania and is the parent corporation of a wholly owned subsidiary, MacCOM, another hypothetical corporation, located in Delaware. Together these two corporations form an affiliated group.[29] After MacCOM is formed, PMG

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345 Park Avenue, New York, New York, 10154-0102, (212)758-9700.

26. Mollenkamp, *supra* note 22, at C1.

27. It could be argued that WorldCom's choice to incorporate their subsidiary in Delaware was motivated by the fact that Delaware does not tax income generated from the use of intangibles. *See* DEL. CODE ANN. tit. 30 § 1902 (1997):

> Imposition of tax on corporations; exemptions
>
> * * *
>
> (8) Corporations whose activities within this State are confined to the maintenance and management of their intangible investments or of the intangible investments of corporations or statutory trusts or business trusts registered as investment companies under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 et seq.) and the collection and distribution of the income from such investments or from tangible property physically located outside this State. For purposes of this paragraph, "intangible investments" shall include without limitation, investments in stocks, bonds, notes and other debt obligations (including debt obligations of affiliated corporations), patents, patent applications, trademarks, trade names and similar types of intangible assets;
>
> * * *

DEL. CODE ANN. tit. 30, § 1902 (1997).

Corporations also establish these IHCs in states such as Nevada, which does not tax corporate income, Michigan, which exempts from tax, interest income and income generated through the payment of royalties, and those states which have combined reporting (resulting in an elimination of intercompany transactions from the corporation's income). Reason, *supra* note 6. *See also*, Simpson *supra* note 3, at A1.

28. Timothy H. Gillis, *States Apply the Federal Sham Transaction Doctrine to Intangibles Holding Companies*, 2003 J. TAX'N. 173. Under Delaware statute, specifically DEL. CODE ANN. tit. 30, § 1902, income received from intangibles is not subject to tax.

29. I.R.C. § 1504 (2002).

> (a) Affiliated group defined for purposes of this subtitle—
>
> (1) In general. The term "affiliated group" means—
>
> (A) 1 or more chains of includable corporations connected through stock ownership with a common parent corporation which is an includable corporation, includable corporations;

I.R.C. § 1504 (2002).

transfers ownership of its intangible property[30] to MacCOM. MacCOM then leases the use of the intangibles[31] back to PMG.[32] PMG is required to pay a royalty fee to MacCOM for the use of intangible property that PMG would previously have been free to use without expense.[33]

Under Section 1501 of the Internal Revenue Code (IRC),[34] corporations in an affiliated group may elect to file a consolidated tax return instead of filing separate returns for the parent company and each of its subsidiaries.[35] The function of the consolidated return is to treat the affiliated group of corporations as a single taxable entity.[36] Because PMG and MacCOM are treated as a single taxable entity, transactions between the two corporations will not generate any income or deduction for the group.[37]

In generating a consolidated tax return, the corporation and its subsidiaries must first compute the taxable income of each member of the group, as if each member were filing separate tax returns.[38] The separate incomes of PMG and MacCOM are required to be prepared on an income statement and filed with separate columns for each member in the group.[39] The income and expense of each member of the group is

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30. "Intangibles" are defined by the Internal Revenue Code under I.R.C. § 936(h)(3)(B) (2002):

> Intangible property. The term "intangible property" means any—
>
> (i) patent, invention, formula, process, design, pattern, or know-how
>
> (ii) copyright, literary, musical or artistic composition;
>
> (iii) trademark, trade name or brand name;
>
> (iv) franchise, license, or contract;
>
> (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
>
> (vi) any similar item, which has substantial value independent of the services of any individual;

I.R.C. § 936(h)(3)(B) (2002).

H.B. 1305 defines intangible property as: "patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets, and similar types of intangible assets." H.B. 1305, 2003-2004 Sess., § (3)(t)(3)(B).

31. For purposes of the hypothetical, "intangibles" refer to PMG's trademarks, patents, and service marks.

32. *See* Simpson, *supra* note 3, at A1.

33. *See infra* Figure 2 accompanying note 71.

34. I.R.C. § 1501 (2002).

35. *Id.*

36. Textron Inc. v. Comm'r, 336 F.3d 26 (1st Cir. 2003). "The consolidated regulations are built on the premise that members of a consolidated group are a single economic entity with regard to intercompany transactions and distributions. . . ." *Id.* at 29.

37. *Id.* (resulting gain or loss from intercompany transaction given effect only when transacted property leaves the affiliated group).

38. 26 C.F.R. § 1.1502-1(a)(1) (2003). *See also* JACK CRESTOL ET AL., THE CONSOLIDATED TAX RETURN: PRINCIPLES, PRACTICE, PLANNING 5-4 (2d ed. 1980).

39. CRESTOL, *supra* note 38, at app. 1 (discussing Regulation Section 1.1502-75(j)). Note that each corporation's separate income will reflect the income or expense

then combined, and adjustments are made to generate the combined income and expenses for the group.[40] The corporation, in what is commonly referred to as the "elimination column," eliminates[41] from the combined income and expenses of the group any income or expense generated by intercompany transactions.[42] The result is the consolidated taxable income for the affiliated group[43] that is filed on Line 28 of Form 1120, the U.S. Corporate Income Tax Return.

In situations where a corporation is required to pay a member of the affiliated group a royalty for the use of an intangible, a deduction can be taken in the calculation of the paying corporation's separate income,[44] thereby reducing the amount of profit the paying corporation realizes.[45] Similarly, the corporation charging for the use of the intangible is able to recognize income.[46] However, because any profit or loss gained from the transactions between members of the affiliated group is eliminated,[47] the income generated from these intercompany transactions is never taxed by

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generated from the transaction between members of the affiliated group. MacCOM's income will include the amount gained from the cost charged to PMG for the use of the intangible property and PMG's income will be reduced by the amount paid to MacCOM. *See id.*

40. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 15-50 (Warren, Gorham & Lamont 5th ed. 1987) (1959).

41. 26 C.F.R. § 1.1502(c)(6)(ii)(A) (2003).

42. *Id.* § 1.1502-13(b)(1)(i).

> (b) Definitions. For purposes of this section—
>
> > (1) Intercompany transactions—(i) In general. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include—
> >
> > > (A) S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized;
> > > (B) S's performance of services for B, and B's payment or accrual of its expenditure for S's performance;
> > > (C) S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditure; and
> > > (D) S's distribution to B with respect to S stock.

Id.

43. BITTKER, *supra* note 40, at 15-50.

44. *Id.* at 15-53.

45. Mazerov, *supra* note 4, at 5-6.

46. BITTKER, *supra* note 40, at 15-50.

47. 26 C.F.R. § 1.1502(c)(6)(ii)(A) (2003).

> (ii) Limitation on treatment of intercompany items as excluded from gross income. Notwithstanding the general rule of paragraph (c)(1)(i) of this section, S's intercompany income or gain is redetermined to be excluded from gross income.

Id.

the Federal Government.[48] Additionally, the IHC will often loan[49] the profits generated from the transaction to other corporations in the affiliated group or distribute the profits as a dividend.[50] The corporation receiving the loan is able to deduct the interest payments as an additional expense against income[51] and is not taxed on the distribution of dividends.[52]

B. IHCs and Pennsylvania Corporate Net Income Tax

While PMG and MacCOM may elect to file a consolidated Return with the federal government, Pennsylvania, under Section 7404 of the Tax Reform Code of 1971 (TRC),[53] does not permit any corporation, subject to Pennsylvania state tax, to file a consolidated tax return that shows the consolidated net income of all members of an affiliated group of companies.[54] Therefore, in Pennsylvania, each member of the affiliated group must file its own return.[55] Those corporations taxed in Pennsylvania have established a nexus[56] with the state that is a "substantial connection between the taxed activity and the taxing state; something beyond mere solicitation."[57] Given this definition, those members of the corporate group who can establish nexus with Pennsylvania are taxed by Pennsylvania on a separate entity basis.[58]

Those members who do not have a nexus with the state, specifically the Delaware IHC in the hypothetical, MacCOM, are not taxed by the state.[59] Therefore, income generated by MacCOM through the lease back of the intangible to PMG may not be taxed by Pennsylvania while PMG, who may be taxed by the state, has reduced its taxable income by the expense paid to use the intangible property owned by MacCOM.

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48. *Id.*

49. Mazerov, *supra* note 4, at 5. *See also* Simpson, *supra* note 3, at A1.

50. BITTKER, *supra* note 40, at 15-51.

51. 26 C.F.R. § 1.1502-13(f)(2)(ii) (2003).

52. I.R.C. § 243 (2002) (dividends paid among affiliated corporations are completely exempt from federal taxes).

53. PA. STAT. ANN. tit. 72, § 7404 (2003).

54. *Id.*

55. *Id.*

56. Corporations who establish sufficient nexus with the state are said to be "doing business" in Pennsylvania. *Id.* A corporation can be said to be doing business when it is 1) doing business in Pennsylvania; 2) carrying on activities in Pennsylvania; 3) having capital or property employed or used in Pennsylvania; and 4) owning property in Pennsylvania. *See* LAURENCE R. CUSACK, J.D., LLM, PENNSYLVANIA TAX HANDBOOK 179 (American Lawyer Media 2000). Note that "doing business" as used within § 7404 is not clearly defined in the tax statutes and the courts have never articulated a definition for the term. *Id.*

57. CUSACK, *supra* note 56, at 181.

58. PA. STAT. ANN. tit. 72, § 7401(1) (2003).

59. *Id.*

Pennsylvania derives a corporation's taxable income from the taxable income calculated by the Federal Government.[60] To determine the taxable income of PMG (the hypothetical parent corporation, which filed a consolidated return with the federal government), Pennsylvania looks to the "taxable income [of the corporation] which would have been returned to, and ascertained by the federal government if separate returns had been made to the federal government. . . ."[61] Because PMG's federal return lists only the group's consolidated income, PMG must generate a "pro forma"[62] Federal Form 1120 return with Line 28 listing only the income generated by the filing corporation, PMG.[63] The income is then increased and reduced by specific additions and deductions allowed by Pennsylvania.[64] Therefore, a corporation's Pennsylvania taxable income is Federal taxable income,[65] plus Pennsylvania additions, minus Pennsylvania deductions.[66] Recall that pro-forma Line 28 is generated by establishing a corporation's earned income and then subtracting any expenses, including expenses paid to a subsidiary for the use of intangibles. As a result, when Pennsylvania adopts a corporation's federal taxable income, this income has been reduced substantially by any cost the corporation has incurred through the lease of the intangibles. However, because the Delaware IHC does not have a sufficient nexus with Pennsylvania, the income the IHC earns from the transfer of the

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60. *Id.* at § 7401(3)(1)(a).

61. *Id.*

62. *Id.* § 7403(a)(1)(2).

> (1) A true copy of its return to the Federal Government of the annual taxable income arising or accruing in the calendar or fiscal year next preceding, or such part or portions of said return, as the department may designate;
>
> (2) If no return was filed with the Federal Government the Report made to the department shall show such information as would have been contained in a return to the Federal Government had one been made;
>
> * * *

Id. at § 7401(3)(1)(a).

"Pro forma" is defined "as a matter of form or for the sake of form." BLACK'S LAW DICTIONARY 1212 (8th ed. 1999). Because the companies in the affiliated group did not file separate tax returns to the federal government, they are required to generate "as a matter of form" a return that the company would have filed had they filed on a separate tax return with the Federal Government. PA. STAT. ANN. tit. 72, § 7407 (2003).

63. 61 Pa. Code § 153(1)(a) (2003). Recall the income calculated for each corporation within the group when determining the group consolidated taxable income.

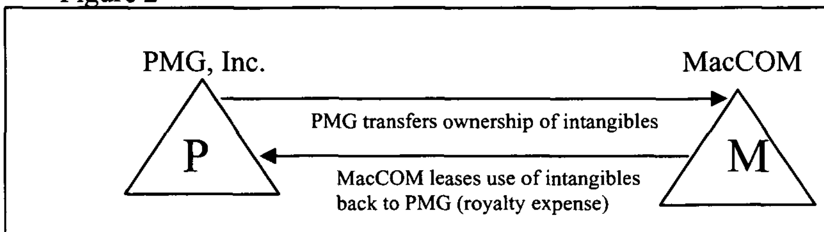
64. Pennsylvania additions include: taxes imposed on or measured by net income, taxes not clearly measured on by net income, federal environmental tax and federal tax preference items. PA. STAT. ANN. tit. 72, § 7401(3)(1)(o) (2003). Pennsylvania deductions include: dividends received that are included in federal taxable income, state and federal interest, depreciation, wages related to federal jobs tax credit and other specialized deductions. PA. STAT. ANN. tit. 72, § 7401(3)(1)(b)-(c) (2003).

65. The Federal taxable income is the income before net operating loss and special deductions, a.k.a. pro forma Line 28.

66. CUSACK, *supra* note 56, at 192.

intangibles is not taxed by Pennsylvania.[67] The income generated by the Delaware IHC is not subject to tax by Delaware because Delaware does not tax income generated by the use of intangibles nor is the income taxed by the Federal Government, which disregards transactions made between members of the same group who have filed a consolidated return.[68] Essentially, this income is generated tax-free.[69] This scenario is problematic when the transactions between the two companies are less than arms-length[70] and are entered into for the purpose of avoiding higher payments of state income tax.

Figure 2[71]



67. *Id.* at 179.

68. *See supra* Part A.

69. E-mail from Marvin Kirsner, Esq., Greenberg, Trauring, LLP, Boca Raton Office (Jan. 7, 2003, 16:19 EST) (on file with author) [hereinafter Kirsner I].

70. To determine whether a transaction is arms-length, a court will evaluate "whether the terms of the transaction under consideration are such as would have been arrived at in independent transactions with or between unrelated parties under similar circumstances." Wisconsin Big Boy Corp. v. Comm'r, 452 F.2d 137, 140 (7th Cir. 1971); *see also*, 26 C.F.R. § 1.482 (2003).

71. Figures 2, 2.1, and 2.2 illustrate how the corporations set up the intercompany transaction and the effect that this transaction has on the amount of income subject to Pennsylvania tax. Figure 2 shows how PMG, the parent corporation transfers ownership of its intangible property to MacCOM, the subsidiary corporation. MacCOM then leases back the use of the intangible to PMG for which PMG pays an expense. Figure 2.1 is a simplified calculation of the taxable income PMG would earn if the intercompany transaction did not occur. After calculating income and expenses, PMG would be taxed on $600,000 worth of income by Pennsylvania. Conversely, Figure 2.2 illustrates the decrease in PMG's Pennsylvania taxable income which is the result of the expense PMG pays to MacCOM for the use of the intangible with a result that Pennsylvania taxes on $350,000 of income as opposed to $600,000 that would have been taxed had the transaction never occurred. Recall that because MacCOM is located in Delaware and cannot establish nexus with Pennsylvania, the $150,000 it has earned in income is not taxed by Pennsylvania. Nor is the income taxed by Delaware, which does not tax income earned from intangibles, or by the federal government, which does not tax income or expenses earned through intercompany transactions.

Figure 2.1

PMG, Inc.	
Income	$1,000,000
Deductions	400,000
Taxable Income	$600,000

Figure 2.2

	PMG, Inc.	MacCOM
Income	$1,000,000	$250,000
Deductions	400,000	100,000
Royalty Expenses	250,000	0
Taxable Income	$600,000	$150,000

III. Plugging the IHC Loophole

With many states facing large budget deficits and struggling to generate additional revenue,[72] it has become imperative that each state develop strategies to combat corporations' "tax sheltering practices."[73] In combating the IHC loophole, states have employed different techniques, including changes in their state corporate tax statutes[74] and challenges to the IHC structure based on arguments developed in the federal courts.[75] The Pennsylvania Legislature, using somewhat of a hybrid strategy, has attempted to close the IHC loophole through the introduction of House Bill 1305 (H.B. 1305),[76] which seeks to alter the

72. Johnson, *supra* note 7.

73. *See supra* Part III.

74. Sixteen states (California, Illinois, Alaska, Arizona, Colorado, Hawaii, Kansas, Idaho, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah) require corporations to file their state taxes under a system of "combined reporting." Mazerov, *supra* note 4. Combined reporting eliminates intercompany transactions by requiring affiliated groups of corporations to add together for tax purposes the profits of the IHC and the corporation paying the royalties and interest and prevents or significantly decreases the probability that the corporation will benefit from the IHC loophole. *Id.* at app. A. Seven states (Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio) have enacted laws that in some form or another prevent corporations from taking deductions for any royalty or interest payments the corporation made to another corporation within the affiliated group. *Id.* These statutes have been a quick fix to the IHC problem, buying states time until they can develop a more comprehensive plan to shut down the IHC loophole. *Id.* at app. A. *See also*, Reason, *supra* note 6.

75. Gillis, *supra* note 28, at 174. These arguments include: 1) economic nexus; 2) distortion of income; and 3) sham transaction. This Comment focuses on the sham transaction argument.

76. H.B. 1305, 2003-2004 Sess., § (3)(t)(3)(B). Introduced by Representative David K. Levdansky to Pennsylvania House of Representatives on May 5, 2003, *available at* http://www.legis.state.pa.us. The author would like to note that after its introduction before the House, H.B. 1305 was referred to the House Finance Committee on May 5, 2003. However, no action was taken on the bill before the 2003-2004 legislative session ended and as such H.B. 1305 failed. *See* HB 1305 History, *available at* http://www.legis.state.pa.us. However the author believes that given the importance of the issue addressed by H.B. 1305 and Pennsylvania's current attempt to reform the way corporations are taxed through the Pennsylvania Business Tax Reform Commission, the

definition of taxable income to permit the state to disallow deductions taken against the corporation's taxable income unless the corporation can show that the transaction that generated the deduction had substantial business purpose and economic substance.[77]

A. Federal Sham Transaction Doctrine

At the federal level, states began challenging the IHC structure with arguments based on economic nexus,[78] distortion,[79] and the sham transaction doctrine.[80] The sham transaction doctrine looks to the purpose of a corporation's transaction and its economic effects to determine if the corporation entered into the transaction because of a valid business purpose or merely as a "sham" to obtain maximum tax benefits.[81] The Pennsylvania General Assembly focused on the sham transaction doctrine, in essence codifying the doctrine in H.B. 1305,[82] in an attempt to close the IHC loophole and recoup lost corporate income tax revenues.

Most courts cite,the United States Supreme Court case of *Gregory v. Helvering*[83] as the origin of the sham transaction doctrine. The

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issues raised by H.B. 1305 will continue to be relevant.

77. *Id. See also,* Gillis, *supra* note 28, at 177. "Substantial business purpose" and "economic substance" are elements which find their source in the sham transaction doctrine which was developed by the federal courts to test the validity of transactions entered into by taxpayers to avoid or lessen the payment of taxes. *Id.*

78. The economic nexus argument, which was first publicized in *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C., 1993), is based on the theory that although the IHC does not have a physical presence within the taxing state, it licenses products to a taxpayer which does have a physical presence in the taxing state and who also uses the products in the taxing state. *Id.* This contact establishes a nexus between the IHC and the taxing state which is sufficient to require the IHC to pay taxes on the income earned from the licensing of the products to the taxing state. E-mail from Marvin Kirsner, Esq., Greenberg, Trauring, LLP, Boca Raton Office (Jan. 7, 2003, 16:22 EST) (on file with author) [hereinafter Kirsner II]; *see also,* Marvin Kirsner, *Congress May Resolve Battle Over Intangible Holding Companies* in *Practical U.S. Tax Strategies*, September 2002, Vol. 2, Number 9 [on file with author]; Gillis, *supra* note 28, at 174.

79. Under the laws of several states, most notably New York, there exits a rebuttable presumption that income is distorted when an affiliated group engages in intercompany transactions. Gillis, *supra* note 28, at 174. The presumption may be rebutted if the corporations can show that the transaction was made at arms-length using fair pricing. *Id.* However companies which fail to rebut the presumption will be required to file a combined return. *Id.*

80. *Id.*

81. Kirsner II, *supra* note 78; *see also,* Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Gillis, *supra* note 28 at 176-177; Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758, 760 (2002) (stating that a "sham transaction" in this context means a transaction that in fact occurred in an effort to exploit a feature of the tax laws, not a transaction that did not occur or did not occur as reported).

82. H.B. 1305, 2003-2004 Session, § (3)(t)(2)(a).

83. 293 U.S. 465 (1935). *See Frank Lyon Co.*, 435 U.S. at 561; *Syms Corp.*, 765

Helvering case dealt with revenue earned by a corporation from the sale of stock the corporation had received from its subsidiary after the subsidiary was liquidated.[84] The parent corporation, United Mortgage Corporation (UMC), was wholly owned by the Petitioner in the case, Gregory, and held as an asset 100 shares of stock in a second corporation, Monitor Securities Corporation (Monitor).[85] Gregory then organized a subsidiary corporation, the Averill Corporation (Averill).[86] Gregory transferred the 1,000 shares of Monitor stock to Averill in exchange for ownership of all the shares of Averill.[87] Shortly after Averill was created, it was dissolved and its assets were liquidated and distributed to its shareholders, namely Gregory through UMC.[88] The Monitor shares were then sold, resulting in a gain for Gregory in excess of $76,000.[89] The Commissioner of the IRS found that Gregory was required to pay a tax on the gain as if UMC had paid Gregory "a dividend in the amount realized from the sale of the Monitor shares."[90] The Supreme Court affirmed.[91] The Court referred to the transaction as "an operation having no business or corporate purpose."[92] In describing the new corporation that was formed the Court stated: "No doubt a new and valid corporation was created. But that corporation was nothing more than a contrivance."[93] The Court concluded by saying that to deem the transaction as anything but a sham would be "[to] exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[94] The thrust of the *Helvering* decision was articulated as recently as 2002 by the court in *IRS v. CmHoldings,*[95] when it stated that "the courts will not elevate the form of the transaction over its substance. Even if a transaction complies precisely with all requirements for obtaining a deduction, if [the transaction] lacks economic substance [the transaction] is simply not recognized for federal transaction purposes."[96] The court in *ACM Partnership v. Commissioner of Internal Revenue*[97]

N.E.2d at 763; Sherwin-Williams Co. v. Comm'r of Revenue, 778 N.E.2d 504, 513 (Mass. 2002); *see also* Gillis, *supra* note 28, at 176.

84. Gregory, 293 U.S. at 465.
85. *Id.* at 467.
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. Gregory v. Helvering, 293 U.S. 465, 467 (1935).
91. *Id.*
92. *Id.* at 469.
93. *Id.*
94. *Id.* at 470.
95. 301 F.3d 96 (3d Cir. 2002).
96. *Id.*
97. 157 F.3d 231 (3d Cir. 1998).

interpreted *Helvering* as requiring the court to look to the transaction to determine what "actually occurred,"[98] rather than the form of the transaction to ascertain the tax consequences of the transaction.[99]

After *Helvering* was decided, courts began to apply the sham transaction doctrine to uphold or strike down taxpayer's business transactions.[100] Over time there was confusion as to whether the doctrine required a rigid two-pronged analysis which required that the courts find the absence of both a valid business purpose and an economic substance for a transaction to be considered a sham or whether all that was required was failure in one area.[101] The debate was seemingly resolved with the decision of *United Parcel Service of America, Inc. v. Commissioner of Internal Revenue* (*UPS*),[102] in which the court applied a more refined sham transaction doctrine and conducted an analysis which was focused "less on the business purpose" of the transaction between UPS and its subsidiaries[103] and more on the "substantive activities of the resulting enterprise."[104] Using the *UPS* analysis, courts would still examine the economic substance and business purpose of a transaction, but the issue

98. *Id.* at 250 (citing *Gregory*, 293 U.S. at 469).

99. *Id.*

100. *See. e.g.*, Frank Lyon v. Comm'r of Internal Revenue, 435 U.S. 561 (ruling that sale and leaseback of building for tax purposes is not a sham because of economic substance); Merryman v. Comm'r of Internal Revenue, 873 F.2d 879 (5th Cir. 1989) (finding that a partnership formed to operate oil rig lacked economic substance and served no purpose other than creation of tax benefits); Sochin v. Comm'r of Internal Revenue, 843 F.2d 351, 354 (9th Cir. 1988) (stating that straddle transactions in forward contracts are a sham).

101. *See* Rice's Toyota World v. Comm'r of Internal Revenue, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."); Casebeer v. Comm'r of Internal Revenue, 909 F.2d 1360 (9th Cir. 1990); *but see* Sochin v. Comm'r, 843 F.2d 351, 354 (9th Cir. 1988) ("[T]he consideration of business purpose and economic substance are simply more precise factors to consider in the application of the court's traditional sham analysis; that is whether the transaction had any practical economic effects other than the creation of income tax losses. . . . Thus the tax court's failure to specifically delineate a two-pronged test and the factual findings to support each prong is not fatal."); ACM Partnership v. Comm'r, 157 F.3d at 247 (3d Cir. 1998); James v. Comm'r of Internal Revenue, 899 F.2d 905 (10th Cir. 1990).

102. 254 F.3d 1014 (11th Cir. 2001).

103. The facts of *UPS* centered around the restructuring of the carrier's excess-value insurance program. *Id.* at 1014. UPS, which used to administer the program in-house, entered into a transaction with an outside insurance company to insure the excess value packages. *Id.* UPS then created a subsidiary corporation which entered into a reinsurance agreement with the insurance company in exchange for a premium in the amount the insurance company received from UPS. *Id.* Because the reinsurance corporation was a subsidiary of UPS, UPS received the fee paid to the subsidiary by the insurance agency however UPS never claimed any income from the program. *Id.*

104. Gillis, *supra* note 28, at 177.

would be less about the motivation of the parent corporation for entering into the transaction and more about the activity engaged in by the newly created subsidiary.[105] Although a corporation's transaction may have as its motivation the reduction of taxes, this motive would not be fatal if it figured into an "existing, bona-fide, profit seeking business."[106] A corporation would not be penalized for altering its legitimate business structure in order to reap the tax benefits that accompany the reorganization;[107] however, the court would find no valid business purpose when the transaction "would not have occurred, *in any form*, but for tax avoidance reasons."[108]

B. State Solutions to the IHC Problem

A few states[109] have begun to apply the reasoning of the *UPS* court and have used the sham transaction doctrine to challenge corporation's IHC structures.[110] Massachusetts has been the forerunner among the states using the doctrine as evidenced by the prominent decisions of *Syms Corp. v. Commissioner of Revenue*[111] and *Sherwin-Williams Company v. Commissioner of Revenue.*[112] These decisions are illustrative of the states' use of the sham transaction doctrine to challenge IHC structures and the relative success of the strategy. Both decisions rely on the arguments set forth by the federal courts regarding the existence of a sham transaction, however each court reached a different result as to whether the transaction entered into by each corporation was in fact a sham.[113]

The facts in *Syms Corp.* reveal a transaction strikingly similar to the one described between the hypothetical corporations PMG and MacCOM. Like PMG, Syms Corp. (Syms) formed a wholly owned subsidiary corporation, SYL, Inc. (SYL) located in Delaware.[114] As in the hypothetical, Syms transferred ownership of its trademarks to

105. *Id.*

106. *UPS*, 254 F.3d at 1020; *see also*, *ACM Partnership*, 157 F.3d at 261.

107. *Id.* at 1019 (stating the concept of business purpose is a corollary to the axiom that taxpayers have a legal right to decrease their tax liability). *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935).

108. *UPS*, 254 F.3d at 1020 (emphasis in original); *see, e.g.*, Rice's Toyota World v. Comm'r of Internal Revenue, 752 F.2d 91 (4th Cir. 1985) (deeming that a sale-leaseback of a computer by a car dealership solely to generate depreciation deductions is a sham).

109. Gillis, *supra* note 28, at 180 ("States have employed the sham transaction doctrine in at least five other instances involving an [IHC]").

110. Kirsner, *supra* note 78; *see also*, Gillis, *supra* note 28, at 173.

111. 765 N.E.2d 758 (Mass. 2002).

112. 778 N.E.2d 504 (Mass. 2002).

113. *Syms*, 765 N.E.2d at 764; *Sherwin-Williams*, 778 N.E.2d at 516-19.

114. *Syms*, 765 N.E.2d at 761.

SYL.[115] After the trademarks were transferred, Syms entered into a licensing agreement with SYL in which Syms agreed to pay a royalty to SYL in exchange for use of the trademarks.[116] The transaction was structured so that SYL would receive the royalty payment from Syms, hold the payment in Delaware for a "few weeks,"[117] and then transfer the payment back to Syms as a tax-free dividend.[118] SYL's only income came from the annual royalty payments the corporation received from Syms.[119] SYL's office consisted of a rented Delaware address which cost SYL an annual fee of $1,200.[120] The transfer and license back of the trademarks did not affect the business operations of Syms; the company still maintained and protected the trademarks, paying the fees of the New York City trademark law firm who performed the service.[121] Syms controlled the advertising and quality control of the trademarks and the choice of which products would be sold under each trademark.[122] The facts indicate that Syms's motivation for entering into the transaction was the reduction of Syms's income taxes.[123]

As in the IHC cases at the federal level, the *Syms* court found that the proper inquiry into the validity of the transaction was found in the sham transaction doctrine and whether or not the transaction had economic substance and business purpose.[124] The court was unclear as to whether this analysis was a two-pronged analysis requiring either an economic substance or a business purpose for the transaction to be valid or instead whether economic substance and business purpose were only factors to consider when determining whether the transaction had any practical effect beyond tax avoidance.[125] The court upheld the Appellate Tax Board's (Board) finding that the transaction between Syms and SYL had no economic effects other than the creation of tax benefits and the only business purpose of the transaction was tax avoidance.[126] The court

115. *Id.*
116. *Id.*
117. *Id.* at 762.
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.* at 761.
124. *Id.* at 762.
125. *Id.* at 764. The court cites both the decision in *Casebeer v. Comm'r of Internal Revenue*, 909 F.2d 1360, 1365 (9th Cir. 1990) (ruling that the taxpayer must show both that the transaction was supported by business purpose other than tax avoidance and had economic substance other than the creation of tax benefit) and *James v. Comm'r of Internal Revenue*, 899 F.2d 905, 908-09 (10th Cir. 1990) (holding that the consideration of business purpose and economic substance are factors in determining whether transaction had any practical effect other than creation of income tax losses).
126. *Syms*, 765 N.E.2d at 764.

focuses its discussion on the business purpose of Syms's transaction, noting that a motive of tax avoidance is not fatal to the business purpose analysis.[127] However, the business purpose must be "more than theoretical musings, concocted to provide faint cover for the creation of the tax deduction."[128] After looking closely at the transaction between Syms and SYL, the court determined that although on the surface the arrangement between the two corporations resembled a legitimate transaction between two viable businesses, the way that the transaction was structured, Syms's continued control over the trademarks, and SYL's retention of Syms's royalty payment for a minimal time period before distributing the payment to Syms as a dividend revealed a sham created for the sole purpose of reducing Syms's taxable income.[129]

The facts in *Sherwin-Williams*,[130] while fundamentally similar to those presented in *Syms Corp.*, are significantly different. Sherwin-Williams formed to wholly owned subsidiary corporations located in Delaware, Sherwin-Williams Investment Management Company, Inc. (SWIMC) and Dupli-Color Investment Management Company, Inc. (DIMC).[131] These corporations were formed with the intent that SWIMC and DIMC would maintain control of the corporation's domestic trademarks.[132] The trademarks were owned by each of the corporations,[133] and Sherwin-Williams paid a royalty fee to each corporation for the use of the trademarks.[134] The royalty fees paid were equal to the fair market value of the trademarks and were determined by an independent appraisal company.[135] After their formation, each subsidiary operated as an ongoing business, entering into nonexclusive licensing agreements with both Sherwin-Williams and unrelated third parties, setting their own investment policies, paying taxes, hiring outside companies to audit the company and perform quality control and hiring, and paying outside counsel to represent them in trademark

127. *Id.* at 764 n.8.

128. *Id.* Among the business purposes offered by Syms and rejected by the Board were protection of the trademarks from creditors and hostile takeovers, better management of the trademarks, and enhanced ability to borrow funds. *Id.*

129. *Id.* at 764-65.

130. Sherwin-Williams v. Comm'r of Revenue, 778 N.E.2d 504 (Mass. 2002).

131. *Id.* at 508.

132. *Id.* at 509. At the board meeting creating SWIMC and DIMC, Sherwin-Williams's board listed eleven reasons for the creation of the subsidiaries including: improved quality control, increased profitability, increased ability to enter into third party contracts, and insulation of the marks from Sherwin-Williams's liability. *Id.*

133. *Id.* SWIMC controlled the trademarks of all nonaerosol products, and DIMC controlled the trademarks of all aerosol products. *Id.* at 510.

134. *Id.*

135. *Id.*

proceedings.[136] Corporate formalities among each of the corporations were strictly observed.[137]

Sherwin-Williams appealed a decision of the Board which upheld a ruling by the Commissioner of Revenue to disallow $47 million in expense deductions that Sherwin-Williams claimed against its 1991 taxable income.[138] Sherwin-Williams claimed these expenses were incurred from royalty payments the company paid to SWIMC and DIMC for the use of the trademarks held by each of the companies.[139] The Board found that the disallowance of these deductions was valid because the "transfer and license back of the [trade]marks was a sham and could be disregarded under the sham transaction doctrine."[140] The Massachusetts Supreme Court, after reviewing the findings of the Board, struck down the decision, holding that the transaction between Sherwin-Williams and its subsidiaries was not a sham and that the expenses incurred from the transaction were properly deducted.[141]

As stated by the court in *Syms*, Massachusetts had recognized the sham transaction doctrine as a means for states "to disregard for tax purposes those transactions that have no economic substance or business purpose other than tax avoidance."[142] The *Sherwin-Williams* court, like the *Syms* court, adopted the use of this doctrine to challenge IHC transactions, but the *Sherwin-Williams* court took the analysis one step further by applying the refined sham transaction doctrine found in the *UPS* decision.[143] The court found that the better analysis was one that required the court to examine whether the transaction had economic effects besides the creation of tax benefits and whether the transaction was formed for a "substantial business purpose"[144] or "substantive business activity."[145] The court found that Sherwin-Williams's use of the IHC structure was valid and that the transaction between Sherwin-Williams, SWIMC, and DIMC was not sham because the transaction had both economic substance and a valid business purpose.[146] In contrast to the Syms transaction, Sherwin-Williams structured its transaction in such

136. *Id.* at 511.
137. *Id.* 778 N.E.2d at 512.
138. *Id.* at 507.
139. *Id.* at 508.
140. *Id.* The board also found the disallowance to be valid under the theory that the royalty payments were not deductible as ordinary and necessary business expenses and that under Massachusetts law, the commissioner could eliminate the royalty payments because they were not made at an arm's length. *Id.*
141. *Id.*
142. *Id.* at 512.
143. *Id.* at 504, 516.
144. *Id.* at 516.
145. *Id.*
146. *Id.* at 508.

a way that even though the creation of the two subsidiary corporations resulted in tax savings for Sherwin-Williams, it also created two unique business entities with real enforceable obligations and responsibilities.[147]

IV. House Bill 1305

Similar to Massachusetts, Pennsylvania has sought to combat the IHC structure by using the sham transaction doctrine to invalidate deductions that arise from transactions between corporations and their IHC subsidiaries.[148] However, rather than challenge the transaction at the judicial level, Pennsylvania has attempted to codify the doctrine through the introduction of H.B. 1305.[149] Reducing the doctrine to statutory form allows the state to combat the IHC structure at the agency level[150] rather than through the courts.[151] However, the bill is structured in such a way that the inquiry into the validity of the transaction may still be decided by the courts; therefore, the effectiveness of H.B. 1305 can be determined by examining the success other states have had when challenging the doctrine in the court.

The primary purpose of H.B. 1305 is to change the definition of taxable income to include income and deductions incurred through a transaction whose principle purpose is the avoidance of state taxes.[152]

147. *Id.* at 518 ("These changes resulted from the reorganization [of the business structure of Sherwin-Williams] . . . [and] are ample evidence of a reorganization that has resulted in the creation of new viable business enterprises"). *Id.*

148. *See* H.B. 1305, 2003-2004 Sess., § (3)(t)(3)(B).

149. *Id.*

> (3) "Taxable income." 1. * * *
>
> (t) (1) Notwithstanding paragraph (a), taxable income shall include the amount of the deduction for interest expenses and costs and intangible expenses and costs paid, accrued or incurred to, or in connection with one or more transactions unless the corporation proves by clear and cogent evidence that the transaction or transactions giving rise to the expenses and costs did not have as a principal purpose the avoidance of any tax due under this article. There shall be a presumption that a transaction between a corporation and a person that is not a related member as defined in this paragraph did not have as a principal purpose the avoidance of any tax due under this article.
>
> (2) Proof that the principal purpose of the transaction was not tax avoidance may be required with the tax report for the applicable taxable year and shall consist of:
>
> (A) Proof that the transaction had a substantial business purpose and economic substance and that the transaction involved was based upon terms and conditions that are arm's length in nature;
>
> * * *

Id.

150. *Id.* at pt. 5, ln. 7 (conferring powers and imposing duties upon the Department of Revenue).

151. *Id.* at pt. 2, ln. 1-12.

152. *Id.* at pt. 2, ln. 1-8.

The pertinent language reads as follows:

> Notwithstanding paragraph (a), taxable income shall include the amount of the deduction for interest expenses and costs, intangible expenses[153] and costs paid, accrued or incurred to, or in connection with one or more transactions unless the corporation proves by clear and cogent evidence that the transaction or transactions giving rise to the expenses and costs did not have as its principle purpose the avoidance of any tax due under this article.[154]

The bill places the burden on the taxpayer to offer evidence that the principle purpose of the transaction is not tax avoidance.[155] The bill goes further to create a presumption that transactions which occur between unrelated entities[156] do not have as their principle purpose tax avoidance.[157] Presumably a corporation may have a tax avoidance motive when engaging in an IHC transaction provided it is not the primary motivation for entering into the transaction. From the bill's language it can also be presumed that once a taxpayer has proven to the satisfaction of the Department of Revenue (Department) that the transaction does not have tax avoidance as its principle purpose, the deductions derived from the transaction are not required to be included in the corporation's taxable income.[158]

The sham transaction doctrine appears in the bill as an element that a corporation must prove in order to rebut the presumption that the transaction was entered into with the primary purpose of tax avoidance:[159]

> (2) Proof that the principle purpose of the transaction was not tax avoidance may be required with the tax report for the applicable year and shall consist of:

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153. The bill defines intangible expenses as "expenses and costs for, related to or in connection with the acquisition, use, maintenance, or management, ownership, sale, exchange or any other disposition of intangible property[.]" H.B. 1305 at pt. 3, ln. 3-5.

154. *Id.* at pt. 2, ln. 1-12.

155. *Id.* at pt. 2, ln. 5-7.

156. *Id.* at pt. 3, ln. 17-22.

> (D) "Related entity" means any of the following:
>
> * * *
>
> > (i) A corporation or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under attribution rules contained in Section 318 of the Internal Revenue Code of 1986, if the corporation owns directly, indirectly, beneficially or constructively, at least fifty percent of the value of the corporation's outstanding stock.

Id.

157. *Id.* at pt. 2, ln. 8-12.

158. *Id.* at pt. 2, ln. 1-12.

159. *Id.* at pt. 2, ln. 13-26.

> A) Proof that the transaction had a substantial business purpose and economic substance and that the transaction involved was based upon terms and conditions that are arms length in nature;[160]

The bill does not define what is required for a corporation to prove that a transaction had business purpose or economic substance,[161] although it should be noted that in order to disprove a primary motive of tax avoidance, a corporation must make a showing that the transaction had *substantial* business purpose and economic substance.[162] Because "substantial business purpose" and "economic substance" are not defined, taxpayers will be forced to seek guidance from the federal and state courts from which the sham transaction doctrine was gleaned[163] in order to determine what must be shown to satisfy these elements. If a taxpayer fails to prove to the Secretary of the Department of Revenue that the transaction's principle purpose is not tax avoidance, the Secretary is authorized by H.B. 1305 to make adjustments to the taxpayer's income to fairly reflect the realities of the transaction.[164]

V. Does House Bill 1305 Really Work?

The Pennsylvania Legislature is off to a good start in its attempt to combat the IHC tax loophole; however, the state's strategy is not as effective as it purports to be. Drawing its strength from the sham transaction doctrine, H.B. 1305, if adopted, allows Pennsylvania to recoup lost tax revenue from those corporations who attempt to avoid taxes through the IHC structure.[165] By codifying the doctrine, Pennsylvania would ensure that every transaction entered into by corporations for the creation of tax benefits must meet the standard of a valid transaction articulated within the sham transaction doctrine without the Department of Revenue having to go through the lengthy, and often times costly, process of challenging each transaction in court.[166] However, upon closer examination, it seems that H.B. 1305, as it is currently written, while effective at challenging those transactions that are transparent tax avoidance schemes, is less successful at avoiding

160. *Id.* at pt. 2, ln. 13-19.

161. *Id.* at pt. 2, ln. 2-4.

162. *Id.* at pt. 2, ln. 16-17 (emphasis added).

163. *See* Gregory v. Helvering, 293 U.S. 465 (1935); United Parcel Service of America, Inc. v. Comm'r of Internal Revenue, 254 F.3d 1014 (11th Cir. 2001); Sherwin-Williams v. Comm'r of Revenue, 778 N.E.2d 504 (Mass. 2002); Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758 (Mass. 2002).

164. H.B. 1305, at pt. 5, ln. 2-6.

165. *Id.* at pt. 2, ln. 1-12.

166. *Id.*

those transactions structured in such a way that satisfies H.B. 1305's requirements while still resulting in enormous tax savings for the corporation.

Similar to the sham transaction doctrine, H.B. 1305 speaks of transactions that have no valid business purpose and economic substance.[167] Corporations must prove that the transaction with their IHC did not have as its principle purpose tax avoidance by showing that the transaction had a substantial business purpose and economic substance.[168] The bill, however, does not contain any definition of what a corporation must show to prove that the transaction contained these elements.[169] Without guidance from the Department, Pennsylvania taxpayers will turn to the courts for a definition of what it means for a transaction to have business purpose and economic substance. This inquiry, in essence, usurps from the Department the power granted by H.B. 1305 to determine which transactions are invalid for Pennsylvania tax purposes and places it back in the hands of the courts. These courts have begun to refrain from categorizing a transaction as a sham unless the corporation can point to no other purpose for the transaction than the creation of tax benefits;[170] a showing that the corporation would not have entered into the transaction if there were no tax benefits to be obtained.[171] The result is that Pennsylvania, even with the codification of the sham transaction doctrine, will only be able to invalidate those transactions structured in a way that makes it obvious to the agency that the sole purpose of the transaction is tax avoidance.[172] Any structure that seems to have a legitimate purpose and effect other than tax avoidance will be upheld even in the face of H.B. 1305.[173] This argument is strengthened by the language of H.B. 1305, which states that only those transactions with a *principle purpose* of tax avoidance may be restructured to include in taxable income any deductions generated through the intercompany transaction.[174] Corporations can overcome this "principle purpose" requirement and save the transaction from being deemed a "sham" by asserting reasons other than the creation of tax benefits as their primary

167. *Id.* at pt. 2, ln. 16-19.

168. *Id.* at pt. 2, ln. 13-19. The taxpayer must also present evidence that the transaction between the corporation and the IHC was conducted at arms length.

169. *Id.*

170. *See, e.g.*, TIFD III-E Inc. v. U.S., 342 F. Supp. 2d 94 (D. Conn. 2004).

171. *See* Sherwin-Williams v. Comm'r of Revenue, 778 N.E.2d 504 (Mass. 2002); United Parcel Service of America, Inc. v. Comm'r of Internal Revenue, 254 F.3d 1014 (11th Cir. 2001); SYL Inc. v. Comptroller of the Treasury (Md. Tax Ct. 1999); Gillis, *supra* note 28 at 178.

172. *See Syms*, 765 N.E.2d at 758.

173. *See Sherwin-Williams*, 778 N.E.2d at 504.

174. H.B. 1305, at pt. 2, ln. 1-12 (emphasis added).

motivation for entering into the transaction.[175]

House Bill 1305 requires corporate taxpayers to show that the transaction between the corporation and the IHC has a *substantial* business purpose and economic substance. Again the bill is silent as to what evidence corporations must present to satisfy this level of proof. Because taxpayers will be forced to turn to the courts for an answer to this question, a closer look at the *Syms* and *Sherwin-Williams* decisions may offer assistance as to what factors a court will examine to determine when a transaction has a substantial business purpose and economic substance. These cases are good illustrations of the types of transactions the courts will consider to be shams. Both cases were argued on the same day and decided by the same court during roughly the same time period; however, the court reached two different conclusions given roughly the same facts.[176] The differences in the way each company structured the relationship with its IHC were the determinative factors[177] which swayed the court into concluding either that the transaction was valid or a sham which could be disregarded for tax purposes. Because H.B. 1305 does not define what it means for a transaction to have a substantial business purpose and economic effect, corporations subject to the provisions of H.B. 1305 need only structure their transaction in a manner similar to Sherwin-Williams, whose transaction was deemed to be valid, to met the requirements set forth by H.B. 1305 to retain the intangible expense deduction. Once these requirements are met Pennsylvania would be powerless under the bill to recoup the tax revenues lost from the transaction.[178]

The corporations in *Syms* and *Sherwin-Williams* set up intangible holding companies.[179] Each parent company transferred ownership of their trademarks to their subsidiaries and then paid a royalty fee to the subsidiary for the use of the trademark.[180] Recall that the *Syms* court found that this transaction had neither economic substance nor a valid

175. *See, e.g., Sherwin-Williams*, 778 N.E.2d at 510.

176. Both cases were argued on September 10, 2001 before the Supreme Judicial Court of Massachusetts. *Syms*, 765 N.E.2d at 758; *Sherwin-Williams*, 778 N.E.2d at 504.

177. Both the *Syms* court and the *Sherwin-Williams* court included a discussion that the royalty payments paid to each IHC were at arms-length rates. *See, Syms*, 765 N.E.2d at 765; *Sherwin-Williams*, 778 N.E.2d at 511. However, because the *Syms* court deemed the transaction between Syms and SYL to be a sham, while the *Sherwin-Williams* court found the transactions to be valid, it would seem that the mere fact that the IHC charged the parent corporation a royalty fee at an arms length rate does not remove from or condemn a transaction to "shamhood." (CITE NEEDED)

178. H.B. 1305 at pt. 2, ln. 1-12. The text of the bill allows the Secretary of Revenue to disregard a transaction only when it is determined that the transaction had as its principle purpose tax avoidance.

179. *Syms*, 765 N.E.2d at 760; *Sherwin-Williams*, 778 N.E.2d at 504.

180. *Syms*, 765 N.E.2d at 760; *Sherwin-Williams*, 778 N.E.2d at 508.

business purpose; therefore, it was a sham which enabled the Commissioner of Internal Revenue to disallow any deductions associated with the transaction.[181] Additionally, recall that the *Sherwin-Williams* court found that the transaction not only had economic substance but that there was also a valid business purpose associated with the transaction.[182] This determination saved the transaction from being deemed a sham, and the corporation was able to claim as a valid deduction the expenses paid to their subsidiaries for the use of the intangibles.[183]

Comparing the structures set up by Syms Corp. and Sherwin-Williams, it is easy to see which factors the court found determinative in its inquires into economic substance and business purpose. Both Syms and Sherwin-Williams set up IHCs in Delaware and transferred their intangible property to the IHC subsidiary.[184] However, where SYL only licensed use of the trademarks back to Syms,[185] SWIMC and DIMC entered into lease agreements with unrelated third parties for the use of the trademarks.[186] These third party contracts not only had an economic effect on SWIMC, DIMC, and Sherwin-Williams, but they also lent credence to the corporation's stated business purposes which Sherwin-Williams had claimed as the reason for the formation of the IHCs.[187] The royalty fees Syms paid to SYL for the use of the trademarks were transferred back to Syms after only a short holding period,[188] whereas SWIMC and DIMC invested the fees paid to them by Sherwin-Williams and earned returns greater than those earned by Sherwin-Williams on comparable investments.[189]

Syms's transfer of the trademarks to SYL did not alter Syms's management of the trademark.[190] Syms was still responsible for the defense of the trademark as well as overseeing the quality control of the trademarks and assignment of the marks to certain products.[191] In contrast, after Sherwin-Williams transferred its trademarks to SWIMC and DIMC, each subsidiary acquired complete control of the trademark.[192] Each company was responsible for determining the uses of trademarks, maintaining quality control and defending the trademarks

181. *Syms*, 765 N.E.2d at 764.
182. *Sherwin-Williams*, 778 N.E.2d at 508.
183. *Id.*
184. *Syms*, 765 N.E.2d at 760; *Sherwin-Williams*, 778 N.E.2d at 508.
185. *Syms*, 765 N.E.2d at 762.
186. *Sherwin-Williams*, 778 N.E.2d at 511.
187. *See supra* note 130.
188. *Syms*, 765 N.E.2d at 762.
189. *Sherwin-Williams*, 778 N.E.2d at 511.
190. *Syms*, 765 N.E.2d at 762.
191. *Id.*
192. *Sherwin-Williams*, 778 N.E.2d at 511.

from lawsuits.[193] Sherwin-Williams observed all corporate formalities in its dealings with SWIMC and DIMC, while Syms treated SYL as an extension of the already existing corporation, rather than a viable, independent entity.[194]

In the final analysis, it appears that courts are likely to find that those transactions that result in the creation or reorganization of a viable business entity will not be found to be shams.[195] For a newly-formed IHC corporation to be deemed viable, the corporation must be more than a pass-through for the parent corporation's assets.[196] The subsidiary should enter into lease agreements, not only with the parent corporation, but also with unrelated third parties and invest the income earned from the lease of the intangible property, instead of distributing the income as a dividend to the parent corporation. The IHC should retain primary control of the intangible: maintaining quality control of the property, making decisions about the use of the property and who may lease the property and assuming responsibility for the protection and defense of the property.[197]

What do these distinctions mean for a corporation faced with defending their transaction against the standard set by H.B. 1305? Corporations doing business in Pennsylvania seeking to take advantage of the IHC structure need only to look to these cases and set up their transactions in a manner similar to those corporations whose transactions were validated.[198] The corporation then ensures that even if challenged as being a sham, they can disprove the allegation by showing that the transaction had substantial business purpose and economic effects.[199] Because corporations can easily develop legitimate ways to act around the requirements of H.B. 1305, the bill in effect has no teeth. The bill offers a challenge to the IHC structure; however, the challenge is one that is not clearly defined and easily circumvented. While H.B. 1305 may initially help Pennsylvania recoup lost corporate income tax revenue, corporations will begin to learn how to structure their transaction in a way that prevents the transaction from being deemed a sham, and H.B. 1305 will be rendered ineffective, throwing Pennsylvania

193. *Id.*

194. *Id.* at 512.

195. *See, e.g.*, *Sherwin-Williams*, 778 N.E.2d at 504; Crown Cork and Seal v. Comptroller of the Treasury, 1999 Md. Tax LEXIS 4 (Md. Tax Ct. 1999); SYL Inc. v. Comptroller of the Treasury (Md. Tax Ct. 1999).

196. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935).

197. *See Sherwin-Williams*, 778 N.E.2d at 516-19.

198. *See Sherwin-Williams*, 778 N.E.2d at 504; Crown Cork and Seal v. Comptroller of the Treasury, 1999 Md. Tax LEXIS 4 (Md. Tax Ct. 1999); SYL Inc. v. Comptroller of the Treasury (Md. Tax Ct. 1999).

199. *Sherwin-Williams*, 778 N.E.2d at 517-19.

back into the quandary that it finds itself in today.

VI. Conclusion

In the era of growing budget deficits, states are becoming desperate to generate much-needed income.[200] Adding to these difficulties is the steady loss in tax revenue that states are experiencing due to the practices of many multistate corporations who take advantage of the loopholes found in state corporate tax statutes to reduce the taxes the corporations pay to the states.[201] One of the more lucrative strategies is the use of intangible holding companies which allow a corporation to reduce its state taxable income by transferring use of its intangible property to an out of state subsidiary and then paying a royalty to the subsidiary for the use of the property.[202] Pennsylvania is among the states hardest hit by these practices, and the state is looking at different ways to combat this drain on its corporate tax revenues.[203] Pennsylvania's strategy has been to use the federally-created sham transaction doctrine, which allows the state to disregard any transaction between affiliated corporations that does not have a substantial business purpose or economic effect, in an effort to invalidate transactions between corporations and their IHC subsidiaries.[204] Pennsylvania has codified the doctrine in H.B. 1305 in an attempt to ensure that all transactions entered into by affiliated corporations, not just those that are challenged in court, conform to the requirement that the transaction be valid and not entered into solely for the creation of tax benefits.[205] By codifying this doctrine, Pennsylvania would be able to challenge these transactions at an agency level instead of wasting time and much needed money fighting each transaction in court.[206] While H.B. 1305 is a step in the right direction towards closing the IHC loophole, the bill does not go far enough and, in the end, will have little effect on Pennsylvania's attempt to recoup lost corporate income tax revenues.[207] As the bill is currently written, only those corporations who blatantly structure their transactions as vehicles created solely for the avoidance of state taxes will have their transactions disregarded, while those corporations who are more subtle about their purpose and can articulate reasons for the transaction other than the creation of tax benefits will not be affected. As corporations become

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200. Simpson, *supra* note 3, at A1.
201. Mazerov, *supra* note 4.
202. *Id.*
203. 2003 TAX DAY, *supra* note 5.
204. H.B. 1305, 2003-2004 Sess., § (3)(t)(3)(B).
205. *Id*, pt. 2, ln. 1-12.
206. H.B. 1305, pt. 5, ln. 7.
207. *See supra* Part V.

increasingly exposed to H.B. 1305 they will learn how to structure their transactions in a way that places the transaction beyond the grasp of H.B. 1305, and Pennsylvania will find itself in the familiar position of having to plug a tax loophole that continues to leak a significant amount of its yearly corporate net income tax dollars.