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Vermont Superior Court Holds Tax Commissioner Incorrectly Determined Insurance Company and Ski Resort Were Unitary

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The Vermont Superior Court has held that the Tax Commissioner's determination that a ski resort was unitary with a parent company that primarily operated insurance businesses was not within the constitutional scope of the unitary business principle.[1] The testimony of the parent company's witnesses described the ski resort as a discrete business enterprise unrelated to the parent company's insurance and financial businesses. Because the Tax Commissioner did not offer a reason to disregard the testimony and presume the businesses were unitary, the record could only support a conclusion that the Commissioner's finding of a unitary relationship was outside the constitutional boundaries of the unitary business principle.

Background

AIG Insurance Management Services, Inc. (AIG) was a conglomerate that owned more than 700 businesses worldwide. Nearly all of AIG's businesses concerned general insurance, life insurance and retirement services, financial services, or asset management. However, AIG also owned a subsidiary, Mount Mansfield Company (MMC), which owned, operated and conducted business as Stowe Mountain Resort, a Vermont ski resort with summer attractions and a year-round lodging and conference business.[2] AIG did not own any other business similar to a ski resort.

In October 2007, AIG filed a 2006 corporate income tax return that included the ski resort in its Vermont unitary group. The Vermont Department of Taxes assessed a tax deficiency based on a mathematical error that AIG made. In December 2008, AIG paid most of the asserted deficiency and the Department abated the remainder. AIG subsequently filed an amended return, in which the ski resort was removed from the unitary group, and requested a refund of nearly $800,000. The Department audited the amended return in 2011 and assessed AIG additional tax of over $60,000, interest and a penalty. Following an appeal by AIG, the Department formally rejected the exclusion of the ski resort from the unitary group and denied the refund request. On appeal, the hearing officer found that the ski resort was part of AIG's unitary group and affirmed the

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[1] *AIG Insurance Management Services Inc. v. Department of Taxes*, Vermont Superior Court, Docket No. 589-9-13, July 30, 2014.
[2] AIG's founder was a skiing enthusiast who repeatedly loaned money to MMC when it was independent and AIG was held privately. After MMC was unable to pay the loans, its ownership eventually passed to AIG.

denial of the refund request and the 2011 assessment of additional taxes. AIG appealed this determination to the Vermont Superior Court.

Unitary Business Principle

Under the unitary business principle, a state may not constitutionally impose an income tax on "value earned outside its borders" under the Due Process and Commerce Clauses of the U.S. Constitution.[3] The principle rejects "geographical or transactional accounting," and allows a state to define the local tax base as including the whole scope of the cross-border unitary business.[4] The Constitution then permits the state to apportion the total income of the unitary business between the part that is fairly attributable to operations within the state and the part that is outside the state.[5]

The contemporary concept of a unitary business emerged in a series of U.S. Supreme Court cases beginning in 1980. In *Mobil Oil Corp. v. Commissioner*, the Court isolated three "factors of profitability" that should be considered: "functional integration, centralization of management, and economies of scale."[6] Where the factors of profitability show that the in-state business is contributing to out-of-state value, it is fair to apportion.[7] However, there is no unitary business if the in-state income "derive[s] from unrelated business activity which constitutes a discrete business enterprise."[8]

Vermont first required unitary combined income tax reporting for tax years starting January 1, 2006.[9] The regulations define a unitary business to be consistent with U.S. Supreme Court decisions.[10]

Ski Resort Not Unitary with Insurance Business

The Vermont Superior Court agreed with AIG that the ski resort was not part of its unitary group. As an initial matter, the Court rejected AIG's argument that the 2011 assessment was barred by the three-year statute of limitations applicable to deficiency assessments[11] and that the "proper return" exception did not apply.[12] According to AIG, the three-year period began to run with the filing of its original return, not its amended return. In rejecting AIG's argument, the Court relied on a Vermont Supreme Court decision holding that an amended return that gives the Department the "full picture of a taxpayer's [altered] liability" is a proper return that restarts the three-year limitations period.[13]

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[3] *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983).
[4] *Id.*
[5] *Id.*
[6] 445 U.S. 425 (1980).
[7] *Id.*
[8] *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980).
[9] VT. STAT. ANN. tit. 32, § 5862(d); VT. CODE R. 1-3-104:1.5862(d).
[10] VT. CODE R. 1-3-104:1.5862(d)-6.
[11] The Commissioner is permitted to assess deficiencies, penalties and interest within three years of the date that the tax liability was originally required to be paid. VT. STAT. ANN. tit. 32, § 5882(a).
[12] The three-year period does not begin to run until the taxpayer files a "proper" return. VT. STAT. ANN. tit. 32, § 5882(b)(1).
[13] *TD Banknorth, N.A. v. Department of Taxes*, 967 A.2d 1148 (Vt. 2008).

According to the Superior Court, the determinative question in the case was whether the Commissioner's finding of a unitary relationship had reasonable support in the record. The Commissioner conceded that AIG was not actively involved in the ski business, but found that AIG was actively involved in the financial operations of MMC such as supporting it with non-arm's-length loans, managing the expansion of the resort, providing financial and asset management expertise and various corporate services, and having authority over all of MMC's capital and borrowing decisions. In addition, the Commissioner found that AIG used the resort to build broker and other business relations to drive AIG business. AIG also offered resort discounts to its 106,000 worldwide employees and families. According to the Commissioner, the resort was dependent on AIG's loans for its financial viability and had a loss of $10 million in 2006 if reported on a separate accounting basis.

The Superior Court explained that "[t]he Commissioner's findings, if adequately supported in the record, probably would be sufficient to warrant unitizing [the ski resort]." However, the Court concluded that the findings "far outrun the evidence, which unambiguously shows that the [ski resort] was a discrete business that did not send taxable value out of state in any appreciable way." Furthermore, the Court determined that the record did not support findings that AIG used the resort for marketing purposes, exerted any significant managerial control over it, or provided any expertise to it. The record did not provide reasonable support that the ski resort, an unintegrated holding far different from anything else that AIG did in 2006, sent taxable value out of Vermont under the unitary business principle. The Court conceded that the resort had contacts with AIG or other businesses owned by AIG in 2006.[14] However, the resort's dealings with AIG mostly were done at arms' length.[15]

After considering the evidence, the Superior Court concluded that the testimony of AIG's witnesses described the ski resort as a discrete business enterprise unrelated to AIG's insurance and financial businesses. Thus, the Commissioner's finding that there was a unitary business was outside the constitutional boundaries of the unitary business principle. AIG was entitled to a recalculation of its 2006 income tax with the resort removed from the unitary group.

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[14] For example, there was testimony that the resort's employees received ERISA-related benefits through AIG, the resort borrowed money from AIG (possibly at below-market rates), the resort received some corporate services from AIG, AIG owned two residences at the resort, AIG companies occasionally would hold conferences at the resort, AIG employees had access to discounts on resort services, an AIG business was a one percent owner of the resort's Spruce Peak project, and AIG did not decide to sell the resort when it was looking for ways to raise money to pay its government bailout.

[15] The Court explained that AIG businesses paid the same as other customers for the conferences. Also, there was no indication that the residences were purchased at special rates. There was no showing that AIG's employees used the discounts at the resort very much. The evidence showed that the investment in the Spruce Peak project was passive. The fact that the resort may have benefitted from below-market financing alone was insufficient to show that it was unitary with AIG's extensive insurance and financial operations. Furthermore, there was no evidence that AIG exercised authority over the resort's capital and borrowing decisions.

Commentary

This decision provides the first reported case with respect to the application of the unitary business principle in Vermont, a relative newcomer to the world of combined reporting. The Vermont Superior Court includes a detailed review of the relevant U.S. Supreme Court decisions and highlights the need to follow the standards expressed in these cases. A unitary business decision is very fact-specific and is sometimes difficult to determine. However, in this case, the facts as indicated in the decision seem to clearly support reversing the Commissioner and holding that AIG and the ski resort were not a unitary business. AIG and the ski resort operated entirely different types of businesses. Although AIG had some transactions with the ski resort, it did not control the resort's daily operations or borrowing decisions nor did it lend any expertise to or make use of the resort for marketing purposes in the year at issue. Because the ski resort was a discrete business, there was no clear showing that it was unitary with AIG.

There are a large number of cases from a variety of states that apply the U.S. Supreme Court's unitary business principle. In most of these cases, courts conclude that the members of the group are operating a unitary business. This case is interesting because it illustrates that a state which follows the U.S. Supreme Court's unitary business principle may conclude that a group is not unitary. The fact pattern in this case is somewhat reminiscent of a California matter involving a corporation that owned and operated 28 commercial properties such as hotels in California, a farm in the state which produced agricultural products, and a cattle ranch in Nevada.[16] The California State Board of Equalization (SBE) held that the cattle ranch in Nevada was not unitary with the California commercial property because they were distinct types of businesses. As explained by the SBE in this matter, "[b]ecause of a lack of uniformity, different types of businesses do not lend themselves to centralization of functions and advantages to be gained by centralization are at a minimum."[17] Therefore, completely diverse business operations that are largely unintegrated may not be unitary. A different result might have occurred if the Department had proven that the use of the ski resort had been tied more closely into AIG's core businesses, for example, if the resort had been used frequently as a means to develop and maintain relationships with companies that utilized the taxpayer to form Vermont-based captive insurance companies.

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[16] *Appeal of Allied Properties*, California State Board of Equalization, SBE-XII-177, 64-SBE-026, March 17, 1964.

[17] *Id.* However, note that the SBE explained that "[w]e do not mean to say that two operations such as a hotel and a ranch should never be treated as unitary." For example, "if the ranch supplied beef to the hotel restaurant, there would be a degree of mutual dependency and contribution which might well call for unitary treatment."

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