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SUPERIOR COURT
WASHINGTON COUNTY

STATE OF VERMONT
WASHINGTON COUNTY

TD BANKNORTH, N.A.,	)	
Taxpayer-Appellant,	)	**Washington Superior Court**
	)	**Docket No. 235-4-06 Wncv**
v.	)	
	)	
DEPARTMENT OF TAXES,	)	
Appellee.	)	

DECISION

This is an appeal by Taxpayer TD Banknorth, N.A., from the Determination of the Commissioner of the Department of Taxes of an assessment of Vermont bank franchise tax for three subsidiary banks for years 2000 and 2001, including interest and a 25% penalty. *Appeal of TD Banknorth, N.A.*, ATC-04-36, Determination. This case presents three issues: 1) whether the Department acted within the three-year limitation period for assessments, 32 V.S.A. § 5882; 2) whether the Commissioner properly applied the "business purpose" doctrine; and 3) whether the Commissioner had authority to impose the 25% penalty.[1]

Background

The underlying assessments of bank franchise tax apply directly to The Howard Bank, First Vermont Bank, and the Franklin Lamoille Bank (the Vermont Banks). Prior to May 2000, each was a wholly owned subsidiary of Banknorth Group, Inc., which was headquartered in Vermont. In May 2000, Peoples Heritage Financial Group, headquartered in Maine, acquired Banknorth, retaining its name. Taxpayer is the successor-in-interest to Banknorth and all relevant subsidiary entities. The issues in this case apply to each of the Vermont Banks in the same manner and are principally unaffected by the fact of the succession of parent corporations. At the hearing, the parties focused on the facts relating to The Howard Bank, stipulating that those facts are representative of the facts relating to the other Vermont Banks. Determination at 6, ¶ 21. To simplify matters, the court will limit its presentation of the facts and analysis to the circumstances of The Howard Bank, unless the context requires otherwise.

Vermont banks pay a "bank franchise tax" (BFT) rather than the ordinary corporate income tax. See 32 V.S.A. § 5836 (bank franchise tax). The BFT is based on a bank's "average monthly deposit," *id.* § 5836(b), and is required to be paid quarterly, *id.* § 5836(c). Two statutory provisions important to this case existed during years 2000 and 2001 and since have been repealed.

First, during the relevant years, a bank's BFT was limited in relation to its "federal

[1] The business purpose doctrine, which is central to this case, is also referred to variously by the parties or in the case law as the economic substance doctrine, the sham transaction doctrine, and the *Gregory* principle, among others.

taxable income." 32 V.S.A. § 5836(e) (repealed).[2] Because the BFT was required to be paid quarterly, but could not be determined with certainty until the bank later computed its federal taxable income, the Department employed the following practice during the relevant periods. A bank would pay the uncapped BFT amount on a quarterly basis using Form BFT1 (Vermont Bank Franchise Tax Return). Once the bank's federal taxable income was determined, if the cap applied, the bank could file Form BFTR (Vermont Bank Franchise Tax Reconciliation Report) along with a copy of federal Form 1120 (U.S. Corporation Income Tax Return). This process allowed the bank to comply with the obligation to make timely quarterly payments of BFT and to take advantage of the § 5836(e) cap.

Second, during the relevant years, a Vermont tax statute unrelated to the BFT provided highly favorable taxation to "investment and holding companies." 32 V.S.A. § 5837 (repealed).[3] Companies meeting the qualifications of § 5837 were liable only for the minimum corporate tax under 32 V.S.A. § 5832 ($250), whereas the general rule is that taxable corporations pay the maximum tax under § 5832.

In 2000, in an effort to take advantage of the favorable taxation of "investment and holding companies," Taxpayer created three "investment company" corporations, each related to one of the Vermont Banks. In the case of Howard Bank, Taxpayer created Northgroup (HB) Investment Company. Howard Bank then engaged in various transactions with its investment company asserted by Taxpayer to have resulted essentially in the investment company's ownership of the right to Howard Bank's income and some of its assets. Ostensibly, this arrangement nearly eliminated Howard Bank's BFT because its federal income would be negative. The lion's share of the bank's taxable income would belong to the investment company; however, the investment company would be taxed at no greater than $250 under 32 V.S.A. § 5837, a win/win for the parent bank and its subsidiary investment company. Together, Howard Bank and its investment company would almost completely escape state corporate taxation.

For example, Howard Bank made quarterly BFT payments in 2000 totaling $777,147 and in 2001 totaling $874,582.[4] In 2002, Howard Bank filed a Reconciliation Report for 2000

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[2] Section 5836(e), now repealed, provided: "The tax imposed by this section shall be limited, in the case of any corporation, for such corporation's taxable year under the federal Internal Revenue Code, to the amount of its federal taxable income (before net operating loss deductions and special distributions) increased by the amount of its income from state and local obligations and by the amount of any deductions taken for the tax imposed by this section provided, however, that in no event shall a corporation pay an amount of tax less than $5,000.00 for its taxable year if its average monthly deposits exceeded $50 million in any month of its taxable year, and $2,500.00 if its deposits were $40 million or less."

[3] Section 5837, now repealed, provided: "The tax imposed by this subchapter [Taxation of Corporations] as it applies to corporations whose activities are confined to the maintenance and management of their intangible investments and the collection and distribution of the income from such investments or from tangible property physically located outside this state shall not exceed the minimum tax provided by section 5832 of this title. For purposes of this section, 'intangible investments' shall include without limitation investments in stocks, bonds, notes and other debt obligations (including debt obligations of affiliated corporations), patents, patent applications, copyrights, trademarks, trade names, and similar types of intangible assets."

[4] The hearing officer found that Howard Bank's BFT for the second quarter of 2001 was $216,292. See Determination at 11, ¶ 46. This appears to be a typographical error. According to the relevant Bank Franchise Tax Return and Reconciliation Report, both available at State's Exhibit 29B, the correct amount paid was $216,393. The

claiming a negative federal taxable income resulting in a claimed overpayment of year 2000 BFT of $772,147. After interest and an offset, this resulted in a net "refund" request of $437,124.50, which the Department paid as requested. In 2003, Howard Bank filed a Reconciliation Report for 2001 claiming a negative federal taxable income resulting in a claimed overpayment of BFT for 2001 of $869,582. After interest and an offset, this resulted in a net "refund" request of $394,033, which the Department paid as requested.

In 2004, recognizing a precipitous decline in BFT revenue, the Department audited the Vermont Banks. Following the audit, the Department provided Taxpayer with a "First Notice of Audit Assessment" with regard to each of the Vermont Banks. In the letter accompanying the notices, the Department's director of compliance explained:

> The additional assessments arise because the Department has collapsed each bank's corresponding subsidiary investment company. Profits attributed to the collapsed entities are attributed to each bank. It is the Department's position that the subsidiaries have no economic substance or legitimate business purpose and were formed merely to evade the Bank Franchise Tax.

Letter from Brenda Vovakes to Roy M. Drukker (dated June 18, 2004), State's Exhibit 60. That is, the Department recalculated the BFT due disregarding the investment companies. The assessment included interest and penalties "Per 32 VSA, Section 3202." Tax Examination Changes Report, State's Exhibit 60. The penalty due in the notice amounted to 25% of the additional BFT found due.

Taxpayer then sought a determination of the deficiency, penalty, and interest by the Commissioner pursuant to 32 V.S.A. § 5883. Prior to the proceedings before the Commissioner, the Department notified Taxpayer of "an increase in the penalty amount from 25% to 100% of the liability pursuant to 32 V.S.A. § 3202," reflecting the Department's assessment that the failure to pay resulted from fraud or the "willful intent to defeat or evade" the tax liability, 32 V.S.A. § 3202(b)(5). Letter from Danforth Cardozo, III, Esq. to Paul P. Hanlon, Esq. (dated Nov. 12, 2004), State's Exhibit 61.

At the hearing before the hearing officer appointed by the Commissioner, Taxpayer argued, among other things, that: 1) the Department failed to assess the BFT for year 2000 within the limitation period at 32 V.S.A. § 5882; 2) the investment companies should not be disregarded by application of the business purpose doctrine, suggesting that no additional BFT should be due; and 3) in any event, no penalty should be imposed.

Based on extensive findings, the hearing officer determined that the assessment for year 2000 was timely, the investment companies were properly disregarded for tax purposes under the business purpose doctrine, and that fraud was not shown but the 100% penalty should be reduced to the originally noticed 25% penalty. Taxpayer then appealed to this court pursuant to 32 V.S.A. § 5885(b).

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hearing officer's findings with regard to Banknorth's refund request, Determination at 14, ¶¶ 55–56, make no sense using the incorrect number, nor does there appear to be any dispute in the record regarding this fact.

Standard

The court reviews this case "on the basis of the record established before the Commissioner." *Piche v. Dep't of Taxes*, 152 Vt. 229, 233 (1989) (citing *State Dep't of Taxes v. Tri-State Indus. Laundries, Inc.*, 138 Vt. 292, 294 (1980)). "[J]udicial review of agency findings is ordinarily limited to whether . . . there is any reasonable basis for the finding." *Tri-State Indus. Laundries*, 138 Vt. at 294; accord *Bigelow v. Dep't of Taxes*, 163 Vt. 33, 35 (1994) (findings not set aside unless "clearly erroneous"). The Commissioner's Determination is presumed "correct, valid and reasonable, absent a clear and convincing showing to the contrary." *Tri-State Indus. Laundries*, 138 Vt. at 294. See also *Morton Bldgs., Inc. v. Dep't of Taxes*, 167 Vt. 371, 374 (1998) (deference must be afforded to the Commissioner's determination).

Statute of Limitations

Generally, the Department must notify a taxpayer of a deficiency "within three years after the date that tax liability was originally required to be paid." 32 V.S.A. § 5882(a). However, "[i]f the taxpayer fails to file a proper return with respect to any tax liability at the time prescribed for its filing, the notification or assessment may be made at any time before the end of three years after the taxpayer files such a return." *Id.* § 5882(b)(1). In this case, the BFT was required to be paid quarterly, and the fourth quarterly payment of year 2000 BFT was required to be paid, and in fact was paid, more than three years before the 2004 assessment. On the other hand, the assessment occurred within three years of Taxpayer's filing of the reconciliation report for 2000 BFT.

The hearing officer determined that the operative "return" for purposes of § 5882(b)(1) is the reconciliation report (Form BFTR), not the earlier filed quarterly BFT returns (Form BFT1). Because the reconciliation report was filed within three years of the 2004 assessment, the hearing officer concluded that the assessment was not time barred.

The hearing officer's interpretation of these statutes is consistent with their plain language. The initial three-year limitation period is triggered by the deadline for originally filing a return, not the date that it is actually filed. 32 V.S.A. § 5882(a). If, however, the timely return is not "proper," then the limitation period is triggered by the filing of the "proper" return. *Id.* § 5882(b)(1). A "return" includes any notification by the taxpayer that the filed return included inaccurate information affecting the tax liability. 32 V.S.A. § 5866(b). In the context of this case, the "proper return" is the one that includes the updated information enabling for the first time the calculation of the tax liability. The obvious purpose of these provisions, read in context, is to ensure that the Department has three years from the point of receiving the information needed to calculate the tax liability to determine whether to conduct an assessment.

In this case, because of the conflict between the requirement to pay BFT quarterly and the provision capping BFT in relation to federal income, which could only be determined later, the quarterly BFT filings necessarily could not reflect the tax liability; that is, they could not include the information necessary for the accurate calculation of capped BFT, if the federal income cap applied. Under § 5866(b), the reconciliation report is a return, and under § 5882, it is the first "proper return" a bank claiming a refund under § 5836(e) would ever file. These statutes do not

give the Department two bites at the same apple; rather, the Department only had one three-year period to determine whether to conduct an assessment once Taxpayer filed the complete information needed to calculate the tax liability. Taxpayer has not shown any error in the Determination on this issue.

Business Purpose Doctrine

Based upon extensive findings, the hearing officer determined that the creation of the Vermont Banks' investment companies and the transactions between them (together, the reorganizations) lacked a business purpose and had no economic substance. Applying the business purpose doctrine, the hearing officer disregarded the reorganizations in determining the Vermont Banks' BFT liability. While Taxpayer disagrees with some of the hearing officer's findings, and argues that the hearing officer failed to make findings regarding some facts, Taxpayer's primary argument is that the hearing officer applied the business purpose doctrine incorrectly to the facts.

The business purpose doctrine is commonly said to have originated with *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Gregory*, the taxpayer was the sole shareholder of a corporation that held shares of a different corporation. The taxpayer sought to sell those shares for her personal benefit. Rather than have the close corporation distribute the shares to her, or sell the shares and distribute the cash to her, she sought to acquire the shares through a "reorganization" of the corporation, which would result in a significantly more favorable tax liability. Complying with the letter, but not the spirit, of the statute under which the "reorganization" was intended to receive favorable tax treatment, she created a second corporation to which the shares were transferred. Within days of the transfer, the second corporation was dissolved; she acquired the shares as part of the dissolution. The Commissioner of Internal Revenue treated the transactions with the second corporation and its dissolution as "nullities," assessing tax as though the shares had been distributed directly to the taxpayer from the first corporation. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

In the circuit court case, in an opinion by Judge Learned Hand, the court agreed that the purported reorganization should be disregarded for tax purposes, but disagreed with the Commissioner's analysis. The issue boiled down not to whether the transactions were nullities (invalid as a matter of contract or corporate law) but to whether the transactions that occurred fit the intent of the statute providing the favorable taxation such that they would be recognized for tax purposes. "[T]hese steps," wrote Judge Hand, "were real, and their only defect was that they were not what the statute means by a 'reorganization,' because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect." 69 F.2d at 811. The court elaborated:

> if what was done here, was what was intended by [the reorganization statute], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true . . . that as the

> articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the [reorganization] section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as 'realizing' any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'

69 F.2d at 810–11.

The Supreme Court affirmed, also viewing the issue as fundamentally one of statutory interpretation. The court stated:

> When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' . . . of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

293 U.S. at 469–70. That is, the taxpayer conducted real transactions, and created a real corporation, but did not conduct a real reorganization in the sense required by the statute that otherwise would have conferred favorable tax treatment.

By 1957, if not before, the difficulty of stating the business purpose doctrine as a legal test, and confusion over how it should be applied, had become manifest. The case of *Gilbert v. Commissioner of Internal Revenue*, 248 F.2d 399 (2d Cir. 1957) is instructive. The *Gilbert* taxpayer made a series of loans, reflected in demand promissory notes, to a close corporation. The characterization of the transactions as loans rather than contributions of capital resulted in favorable tax treatment for the taxpayer and the corporation. The tax court ruled that the loans

really were contributions not giving rise to bona fide debts of the corporation. *Id.* at 407. The implication in the majority opinion is that the tax court misconstrued the legal implications of the taxpayer's tax avoidance motives, and consequently failed to frame the analysis in a reviewable manner. With regard to motive, the court said:

> Where the courts have spoken of tax avoidance motives, they have as a rule had reference to their conclusions rather than to the evidence. The statement that the taxpayer was seeking to avoid taxes has been used as the equivalent of the statement that the taxpayer has tried to base a deduction on an advance which was in fact too risky to qualify as a loan for tax purposes. As we have shown, the motives and expectations of the taxpayer are relevant only insofar as they contribute to an understanding of the external facts of the situation.

Id. The majority said that the operative principle—what the tax court missed—is that the transactions, "even though real, may be disregarded if they are a sham or masquerade or if they take place between taxable entities which have no real existence. The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact." *Id.* at 406. The court then remanded for additional findings because it was unable to understand the legal basis for the tax court's conclusion, and "it is difficult to know whether the Tax Court meant to hold that because of some secret agreement the parties did not establish a debtor-creditor relationship in any sense, or that although such relationship was established it did not give rise to debts as that term is used in the Internal Revenue Code." *Id.* at 407.

Judge Hand dissented, objecting to, among other things, the majority's description of the analysis to be applied following *Gregory v. Helvering* and ensuing cases. Rather than empty expressions like "sham," Judge Hand distilled the principle in *Gregory* to this:

> The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.

Id. at 411 (Hand, J., dissenting). The doctrine "covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally." *Id.* at 412 (Hand, J., dissenting). Accordingly, the analysis should be focused on whether the conduct ostensibly outside the particular tax statute in fact was designed to affect the taxpayer's "beneficial interests in the venture, other than taxwise." *Id.*

Despite a great volume of litigation over the years, courts continue to express the core principle of *Gregory v. Helvering* in varying ways. *See Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E.2d 504, 513–16 (Mass. 2002) (analyzing the various legal tests said to embody the *Gregory* principle). Two recent business purpose doctrine decisions of the Massachusetts Supreme Judicial Court, however, provide a useful framework for analyzing this case. *Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E.2d 504 (Mass. 2002); *Syms*

Corp. v. Commissioner of Revenue, 765 N.E.2d 758 (Mass. 2002).

In *Syms* and *Sherwin-Williams*, the taxpayer-corporations had created Delaware subsidiaries ostensibly to own and manage certain intangible assets, primarily "marks," such as trademarks. The parent-corporations then entered "transfer and license-back" agreements with their subsidiaries resulting in, essentially, deductions related to the agreements for the parent corporations in Massachusetts. Meanwhile, the subsidiaries, it was intended, would take advantage of a provision in the Delaware tax statutes making their income tax-free. The Commissioner of Revenue disregarded both such "reorganizations" as lacking any business purpose or economic substance other than tax avoidance. The Court agreed with the Commissioner in the case of *Syms*, but reversed in the case of *Sherwin-Williams*.

The Court in the latter case, Sherwin-Williams, generally described the framework for analysis in a manner de-emphasizing the form of the legal test—which has proven to be a consistently contentious matter in many cases following *Gregory v. Helvering*—and emphasizing the purpose of the doctrine and the substantive issues at stake. The Court framed the analysis as follows:

> [W]hether a transaction that results in tax benefits is real, such that it ought to be respected for taxing purposes, depends on whether it has had practical economic effects beyond the creation of those tax benefits. In the context of a business reorganization resulting in new corporate entities owning or carrying on a portion of the business previously held or conducted by the taxpayer, this requires inquiry into whether the new entities are "viable," that is, "formed for a substantial business purpose or actually engag[ing] in substantive business activity." In making this inquiry, consideration of the often interrelated factors of economic substance and business purpose is appropriate.

Sherwin-Williams, 778 N.E.2d at 516 (citation omitted).

The Syms reorganization should be disregarded for tax purposes, concluded the Court, because the taxpayer was unable to show any business purpose to it other than "theoretical musings, concocted to provide faint cover for the creation of a tax deduction." *Syms*, 765 N.E.2d at 764. The subsidiary essentially had no function other than to receive an annual royalty payment from the parent, which was then paid back to the parent shortly thereafter as a tax-free dividend. *Id.* at 762. Syms' business operations with regard to the marks did not change after the reorganization. *Id.* at 762. The individuals who were responsible for the marks before the reorganization continued to have the same responsibilities after the reorganization. *Id.* The subsidiary hardly even had a presence in Delaware, where it rented an office address from an accounting firm that provided the same "service" to hundreds of other corporations. *Id.* The reorganization simply "had no practical economic effect on Syms other than the creation of tax benefits." *Id.* at 764.

The reorganization in the *Sherwin-Williams* case, on the other hand, produced essentially the same favorable tax treatment sought by Syms, but the Sherwin-Williams reorganization was not be disregarded because the subsidiaries were viable businesses in the sense that they were

really engaged in substantive business activity. Unlike the Syms subsidiary, the Sherwin-Williams subsidiaries retained the royalty payments they received from their parent, and invested in their ongoing business activity, outside of Sherwin-Williams' control, with a goal of earning additional income. *Sherwin-Williams*, 778 N.E.2d at 518. The subsidiaries acquired not just legal title and physical possession of the marks, but also the real "benefits and burdens of owning the marks." *Id.* at 517. The subsidiaries generally took responsibility for the maintenance and defense of the marks, incurring real expenses and paying for related services. *Id.* "In sum, the subsidiaries became viable, ongoing business enterprises within the family of Sherwin-Williams companies, and not businesses in form only, to be 'put to death' after exercising the limited function of creating a tax benefit." *Id.* (quoting *Gregory v. Helvering*, 293 U.S. at 470).

The findings in this case make clear that the Vermont Banks' "reorganizations" far more closely resemble the hollow reorganization in *Syms* than the substantive one in *Sherwin-Williams*. Briefly summarized, the hearing officer found as follows. The idea of creating the investment holding companies originated exclusively as a plan to reduce taxes. Determination at 3–4, ¶ 10, and at 6, ¶ 23. Each parent made tax-free assignments of securities to its subsidiary and entered into 100% "loan participations" with it; the parent became the subsidiary's sole-shareholder. *Id.* at 6, ¶ 25. The loan participations were intended to give the subsidiaries "100 percent undivided interest in the loans" without affecting the parents' management or administration of the loans, or relationship with borrowers. *Id.* at 7–8, ¶ 31. The subsidiaries' "participated" exposure to the loans included no greater than nominal economic risk. *Id.* at 9, ¶ 35. The subsidiaries had no office space, no real property, no tangible assets, no employees, and no payroll. *Id.* at 6, ¶¶ 28–30. They also had no bank accounts; payables and receivables were simply reflected in various book entries. *Id.* at 7, ¶ 30.

Throughout 2001, Banknorth erroneously booked significant income to Howard Bank rather than its investment company subsidiary. Evidently, neither Howard Bank nor its investment company were aware of the error until the Tax Department brought it to Taxpayer's attention. Then, the income was moved to the investment company for tax purposes, but not for book purposes "because the books had been closed." *Id.* at 10, ¶ 39. The obvious implication is that the investment company had no real stake in the erroneously booked income. As a result of these "reorganizations," the Vermont Banks reported losses, for state income tax purposes, *id.* at 9, ¶ 37, while they continued to show profits for consolidated federal purposes, *id.* at 10, ¶ 40. The investment companies never engaged in any meaningful business with third parties. *Id.* at 9, ¶ 36. At the end of 2001, the investment companies were dissolved. *Id.* at 13, ¶ 51.

These facts reveal the investment companies as "bookkeeping entit[ies]," not viable businesses engaged in substantial business activity. *Comptroller of the Treasury v. Syl, Inc.*, 825 A.2d 399, 401 (Md. 2003) (quoting the underlying decision of the hearing officer). The investment companies appear to have been intended to have no business purpose whatsoever other than to facilitate the avoidance of the parent-banks' BFT, and that is how they were operated.[5] The reorganizations were an elaborate way of assigning the Vermont Banks' income

[5] As Taxpayer itself makes clear, the issue of whether the investment companies fit within the meaning of the investment and holding company statute, 32 V.S.A. § 5837 (repealed), is irrelevant: they either did or did not. "The controlling issue as to the assessments that are actually at issue is whether the Banks' Holding Companies had economic substance, so that they should be respected as separate taxpayers, not whether the Legislature intended

to the investment companies exclusively for Vermont income tax purposes, not to create new viable businesses in the Banknorth family of businesses. It is not clear whether the investment companies, as composed, could have done anything else, but the findings leave no question that they never did do anything else. No facts suggest that their creation, existence, or dissolution had any practical economic effect whatsoever on the Vermont Banks' beneficial interests. In these circumstances, even though the investment companies may have been real corporations, and the Vermont Banks' transactions with them also may have been real, the hearing officer correctly disregarded them for tax purposes.

Taxpayer's legal arguments are not persuasive. Taxpayer argues that the reorganizations should be respected because the investment companies legally owned their assets, were real corporations and corporate formalities had been observed, and they transacted the minimal business sufficient to maintain an identity apart from their shareholders. These arguments, however, only suggest that the corporations created and the transactions conducted were "real" in the sense of being technically valid as a general contract or corporate law matter. As has been discussed above, the business purpose doctrine is not predicated on the invalidity of the corporate form and subject transactions. The fundamental issue is whether a reorganization should be disregarded for tax purposes because it amounts to a tax avoidance "contrivance." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

Taxpayer also argues that the investment companies were exposed to economic risk and did conduct business with third parties, such as the Federal Home Loan Bank (FHLB). The transactions with the FHLB, however, facilitated the reorganization, and did little, if anything, more. Whatever exposure to risk that the investment companies technically experienced, the facts do not demonstrate that the investment companies acted as though they had any independent stake in the risks and opportunities associated with the business they were ostensibly conducting. Neither the exposure to economic risk nor the investment companies' contact with the FHLB indicate "substantial business activity" in the sense required by the business purpose doctrine.

Taxpayer asserts that its subjective motivation to reduce taxes is irrelevant to whether the reorganizations should be disregarded for tax purposes. With this the court agrees. The analysis should be, and has been, appropriately based on business purpose as demonstrated by actual conduct, not on subjective intent to decrease taxes.

In an appendix to its August 1, 2006 Memorandum of Law, Taxpayer argues that the hearing officer made certain findings that are not supported by evidence presented at the hearing, and that the hearing officer failed to make other findings necessary to an accurate portrayal of the material events of this case. All such requests relate to facts relevant to the business purpose doctrine issue. The court concludes that the alterations to the findings requested by Taxpayer, even if adopted, would not have a material effect on the analysis above.

Holding Companies to be used in the manner in which the Bank sought to use them." Appellant's Memorandum of Law at 44 (filed Aug. 1, 2006).

Penalty

In the original notice of assessment, the Department notified Taxpayer of a 25% penalty citing generally to 32 V.S.A. § 3202. Prior to the hearing, the Department provided a second notice of assessment to notify Taxpayer of a 100% penalty, citing generally to 32 V.S.A. § 3202.

In the Determination, the hearing officer declined to impose the 100% penalty, which applies specifically to fraud and willful tax evasion. 32 V.S.A. § 3202(b)(5). Rather, the hearing officer imposed the originally noticed 25% penalty. The 25% penalty applies to either taxpayer negligence or an understatement of tax by at least 20%. 32 V.S.A. § 3202(b)(4). The hearing officer reasoned that the 25% penalty should be imposed due to the understatement of tax.

Taxpayer argues, essentially, that the authority to impose a penalty was circumscribed by the content of the notice provided in the second notice of assessment. Because the hearing officer chose not to impose the 100% penalty in the operative notice of assessment, argues Taxpayer, there was no authority to impose any penalty at all. Under 32 V.S.A. § 5883, the Commissioner could not "make up new assessments after the fact." Appellant's Memorandum of Law at 22 (filed Aug. 1, 2006).

Taxpayer did not lack notice that the Department would seek a penalty at the hearing. Both notices of assessment indicated as much, and each cited generally to the penalty statute. Taxpayer's unlikely reading of the penalty statute would require the Department to make an all-or-nothing decision about what penalty to include in the notice because the rejection of a fraud penalty would automatically result in no penalty whatsoever, as if the conclusion that fraud did not occur necessitates the conclusion that negligence or an understatement did not occur. No facts suggest that the Department ever intended to limit its request for a penalty in that manner.

Additionally, the hearing officer was not bound to the terms of the notice of assessment anyway. Nothing in 32 V.S.A. § 5883, suggests that the Commissioner's determination is limited by the scope of the Department's underlying assessment. Section 5883 creates an opportunity for an assessment under the direct supervision of the Commissioner if the taxpayer is not satisfied with the Department's assessment. It does not limit the Commissioner's authority to make the assessment that the facts presented at the hearing warrant. The Commissioner has specific statutory authority to "waive, reduce or compromise any of the tax, penalties, interest or other charges or fees within his or her jurisdiction," 32 V.S.A. § 3201(a)(5).

Taxpayer also argues that, in any event, there has been no understatement of tax in the circumstances of this case because Taxpayer paid the full BFT and only later sought a "refund." The characterization of the reconciliation report and process as a "refund request" belies its actual nature. Petitions for refunds are provided for at 32 V.S.A. § 5884. Taxpayer does not maintain that the reconciliation report was a petition for a refund within the meaning of § 5884 and the Department never treated it as such. The tax liability could not be fully determined until federal taxes had been calculated. That information was first presented to the Department in the reconciliation report, which functioned as a return, not a refund request.

Taxpayer has not demonstrated any error in the Determination.

ORDER

For the foregoing reasons, the Determination of the Commissioner is affirmed.

Dated at Montpelier, Vermont this 1st day of March 2007.

Mary Miles Teachout
Superior Court Judge