

- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- APPELLATE LITIGATION
- AVIATION
- BANKING
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- CLASS ACTION DEFENSE
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- INTERNATIONAL FINANCIAL SERVICES
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESTATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
- WHITE COLLAR CRIME

LOUISIANA SUPREME COURT HOLDS DELAWARE HOLDING COMPANY IS TAXABLE BASED ON COMMERCIAL DOMICILE IN LOUISIANA

By

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The Louisiana Supreme Court has held in *Kevin Associates, L.L.C. v. Crawford*, Docket No. 03-C-0211 (La. 1/30/04), that a Delaware intangible holding company had nexus with, and was commercially domiciled in, Louisiana and thus could be subjected to Louisiana corporation income and corporation franchise taxes. The court based its determination on its finding that the company was managed and controlled in Louisiana even though it had no property or employees there. On the positive side for taxpayers, the court appears to have based its holding that the imposition of the tax satisfied U.S. Commerce Clause nexus standards on the fact that it found the taxpayer to be physically present in the state. Even though the finding of physical presence was debatable, this holding would appear to indicate that the court does not agree with the Louisiana Department of Revenue's position that a physical presence is not necessary for income tax nexus purposes. This will be beneficial for Louisiana taxpayers that are currently undergoing audits relating to out-of-state trademark holding companies in which Louisiana is asserting that a physical presence is not necessary for state income tax purposes based on the South Carolina Supreme Court's holding in *Geoffrey v. South Carolina*, 437 S.E. 2d. 13 (S.C. 1993).

Kevin Associates involved a Delaware intangible holding company set up by the now defunct Katz and Besthoff (K&B) drug store chain. In 1991, K&B formed three subsidiaries to hold certain intangibles. The subsidiary at issue here, Yendis, was formed to hold the stock of various subsidiaries that owned real estate in Louisiana and other southeastern states and to make loans to affiliated corporations. Yendis was formed in Delaware and had no employees, property or payroll in Louisiana. Yendis' only connection to Louisiana was that it earned dividend income from a Louisiana subsidiary and had officers and directors that lived in the state. Yendis had some board of directors meetings in Louisiana and maintained its corporate books there. It also had letterhead that, because of a "clerical error," listed New Orleans as the main address for Yendis. Yendis had no employees in Delaware and rented space in a file drawer from a law firm there.

The Louisiana Department of Revenue asserted that Yendis had no activity in Delaware and was actually commercially domiciled in Louisiana, where management decisions were made regarding the company. Yendis argued that it operated as a holding company in Delaware to receive dividends from subsidiaries and make loans to affiliates and thus the minimal activity necessary to direct this function could be performed in Delaware without substantial activity. It further argued that the activities of its officers and directors in Louisiana were "ministerial" and were actually performed as employees of another K&B service company and not as directors of Yendis. Both the trial court and the Louisiana First Circuit Court of Appeal had held that the presence of officers and directors in the state was not sufficient to create a commercial domicile in Louisiana and that a non-resident parent company could not be subjected to tax based solely on the presence of a subsidiary in the state.

- ADMIRALTY & MARITIME
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- APPELLATE LITIGATION
- AVIATION
- BANKING
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- CLASS ACTION DEFENSE
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- INTERNATIONAL FINANCIAL SERVICES
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESTATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
- WHITE COLLAR CRIME

In order to tax the income of Yendis, the Department had to demonstrate that Yendis' activities in Louisiana were sufficient to create nexus in the state and, if so, that Yendis' commercial domicile was in Louisiana so that the dividend income it earned would be allocated to Louisiana. Under Louisiana law, the intangible income at issue in this case is treated as allocable income and is allocated to the commercial domicile of the taxpayer. In attempting to define commercial domicile, the court cited several cases stating that a corporation that maintains a "paper domicile" or that has minimal operations at its legal domicile will be considered to be commercially domiciled at the place where the corporation is managed. However, these cases can be distinguished from the facts in *Kevin Associates* because the taxpayers in those cases had more than just officers and directors in Louisiana on which to base a determination of commercial domicile. The Department's own regulations state that commercial domicile cannot be assigned to the state where the taxpayer has "no substantial operation or facility" and that the "location of board of directors' meeting is not presumed to create commercial domicile." A holding company by its nature will not have substantial operations or facilities in any state, which is why it is difficult to determine a commercial domicile for such an entity outside of its state of legal domicile. To base the right to tax Yendis' income in Louisiana on the fact that Yendis does very little in its state of legal domicile is an odd theory to assert regarding a company whose purpose is to do very little in its state of legal domicile. The fact that it performed a few of its minor ministerial activities in Louisiana would appear to fall short of the types of contacts found to establish commercial domicile in the cases cited by the court.

The court also found that imposing tax on Yendis based on the fact that it was managed in Louisiana was sufficient to satisfy the U.S. Constitutional nexus requirements of the Due Process and Commerce Clauses. The court found that the minimum contacts requirement of the Due Process clause was satisfied by Yendis "substantial contact" with Louisiana through its management functions being performed in the state. In regard to the Commerce Clause, the court held that the presence of the officers and directors making management decisions in the state was sufficient to satisfy the physical presence requirement of the Commerce Clause.

This is significant in that the Louisiana Supreme Court has applied the physical presence nexus requirement of *Quill v. North Dakota*, 504 U.S. 298 (1992) to a case involving income and franchise taxes. Many states have challenged the application of *Quill* to a state income tax because that case dealt only with the collection of use tax. State court decisions have come down both ways over the past few years. Such a holding could be a blow to the Department's efforts to assert that out-of-state trademark holding companies should be required to file state corporate income and franchise tax returns based on "economic presence" in the state even though they are not actually physically present in Louisiana.

While the holding that Yendis was commercially domiciled in Louisiana appears at first glance to be a poor result for Louisiana taxpayers with intangible holding companies, this case might not be that widely applicable. On more than one occasion in the opinion, the court emphasized that its decision was based on its finding that, based on the specific facts of the case, many of which were stipulated by the parties, Yendis had its commercial domicile in Louisiana. Taxpayers that have properly structured and operated their intangible holding companies, such that management activities have not taken place in Louisiana and sufficient substance has been established in Delaware, should take comfort in this decision that their structures should survive challenge by the Department. Had K&B

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**EMPLOYEE BENEFITS, ERISA, &
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**HEALTH CARE LITIGATION,
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**INTELLECTUAL PROPERTY &
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INTERNATIONAL

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LABOR RELATIONS & EMPLOYMENT

**MEDICAL PROFESSIONAL &
HOSPITAL LIABILITY**

MERGERS & ACQUISITIONS

PRODUCTS LIABILITY

PROFESSIONAL LIABILITY

PROJECT DEVELOPMENT & FINANCE

PUBLIC FINANCE

**REAL ESTATE: LAND USE,
DEVELOPMENT & FINANCE**

**TAX (INTERNATIONAL,
FEDERAL AND STATE)**

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PERSONAL PLANNING**

**VENTURE CAPITAL &
EMERGING COMPANIES**

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taken the steps necessary to properly structure their operations, it appears that the Department might have had a difficult time proving a Louisiana commercial domicile for Yendis.

On a positive note for taxpayers, the Louisiana Supreme Court specifically recognized the long-recognized doctrine that businesses are free to structure their affairs so as to minimize taxation. Throughout the entire case, the Department attempted to convince the court that it was somehow improper for Yendis to arrange its affairs in order to minimize taxation. The court laid this mis-guided argument to rest in favor of the taxpayer.

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- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- INTERNATIONAL FINANCIAL SERVICES
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
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- TAX (INTERNATIONAL, FEDERAL AND STATE)
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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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